CORPORATE MANAGEMENT

(The Directors and Executives)

By

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INTRODUCTION

We are living today on an American capitalistic democracy. By revolution, we secured a system of democratic political government. By a process of evolution, our economic capitalism and our political democracy have become inextricably interwoven, with our capitalism dominated by our corporate system. Thus, democracy, capitalism, free enterprise, competition, profit, politics, subsidy, each has become a thread forming a pattern that has made the American system, with its functions and privileges, a watchtower for the world.

Today's world struggle is to maintain our system and to keep it thriving and prosperous despite the onslaughts of socialistic and communistic propaganda. To accomplish this, each of the threads that constitute the system must be kept pliable and adapted to the needs of the pattern.

This is the task of each American citizen. In the corporate world, it becomes the supreme task of each stockholder, director and corporate executive. Each of these has here a responsibility that, on occasion, may transcend his right to individual or corporate profit.

The corporate scheme is no modern invention. However, as with most ancient devices, early economic associations were rude concepts as compared with today's corporate assemblies. And it is this very growth of corporate power and its impact upon our political democracy that carries with it a host of responsibilities shared by executives, directors and stockholders alike.

Except as it recognizes the dollar as the unit of con-

trol, the democratic scheme of corporation control and management conceived and fabricated by the law, is in essence the political scheme provided for the conduct of our political affairs. As in the case of the latter, it makes its obeisance to democracy by according the stockholder the opportunity periodically to elect his representatives; the practicalities of operations are served, as they must be for efficiency, by giving interim autocratic control to those elected to exercise it. And as the political scheme is thwarted by the practicalities, so we find in the economic scene, similar and comparable abuse.

Some of these abuses may be laid at the doorstep of our corporate law. Not only do the corporate laws of our various states vary, but the main body of corporate law, as always with the law, has been a laggard; moving slowly when at all. With rare exceptions, despite years of discussion and deliberation by our lawmen, our corporate law still clings to roots fabricated in a day when the corporation was a means whereby a Rhode Island millowner or a Cape Cod sea captain could share with his friends and neighbors the profits and losses of his venture, when a meeting of stockholders would be a microcosm of the New England communal town meeting. But today E. I. duPont de Nemours and Company, Incorporated, is owned by more than 146,000 stockholders, and General Motors Corporation has 270 million shares outstanding, while American Telephone and Telegraph has outstanding more than 45 million shares of stock held by more than a million and a quarter stockholders. Yet despite the seven-league boots with which corporate enterprise has been striding, the law has moved behind it at a tortoise-

like pace. With those rare exceptions which occur in consequence of some grave and notorious public scandal, the legislative changes in our corporate law have been the result of corporate pressures, so that the body of the law, which was not designed to meet the new and multifarious problems caused by the large and unwieldy corporate growth includes no comparable remedies.

Thus, with some exceptions, the law applicable to the incorporation and conduct of the privately owned corner grocery store is still the law that governs the far-flung public empires of General Motors and Standard Oil.

Throughout our consideration of the various corporate problems, it must be borne in mind that, though periodic repetition is lacking, we are here attempting to fit the academics of legal compulsions and the consequences of practical human actions into a single working mould for a publicly-owned corporate enterprise of average size and activity. Nevertheless, no mean or moderation will adequately serve the extremes. Nothing we can conclude, or corporate executives may do, will serve to provide a common solution for the uncommon problems of the corporations at either end of the arc; the small one-man real estate corporation organized to avoid personal liability in the operation of an apartment house, at one extremity, and the huge industrial corporation with its many thousands of stockholders at the other. And as we discuss particular problems, this will become apparent.

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PART I

Directors, Management and Stockholders

CHAPTER I

Selection of Directors

§ 1. No Legal Machinery for Selection.

The directors of a corporation are elected by its stockholders. So the law provides and this injunction is faithfully observed in the corporate world.

But before directors can be elected, the candidates for the office must be selected. Who is to select them? The law says the stockholders shall elect them; it does

not say explicitly that the stockholders shall select them, though one might assume that it so implies.

Obviously, when the fictitious Massachusetts mill-owner, to whom we adverted in the Introduction, went to his friends in the town for contributions to his enterprise and a dozen or more joined with him, it was a simple matter, and the natural course of events, for the assembled dozen or more stockholders to meet, discuss and select the prospective directors they were going to elect. Any other course would have been unthinkable. So the law made no special provision for the selection of directors beyond providing that they should be nominated and elected at a single meeting of the stockholders.

As the corporate promoters of Blackstone's day did not envisage a General Motors or a Standard Oil, so the lawmakers did not contemplate the need of providing for the selection of directors in advance of a meeting at which thousands of disassociated shareholders would be present or represented.

In consequence, when directors are to be elected, the first notice the stockholders receive is one for the holding of an annual meeting for their election. Even in the best managed corporations, the stockholders are not asked whom they desire to nominate. Indeed, they are not told that directors are to be selected; instead, they are advised, at best, whom the management has selected and they are asked to give management their proxies so that their votes may be cast in accordance with management's desire. Interestingly enough, on this score, if the meeting is to vote upon the selection of accountants, or concerning some policy proposal, the proxy furnished by management makes provision

so that the stockholders may indicate a negative vote; but so far as the election of directors is concerned, the Russian one-party system of yes controls the management proxy.

As stated later, in connection with our discussion of proxies, many managements, in transmitting proxies to their stockholders for election of directors, give no intimation of the persons for whom the proxy will be voted for directorships; and this practice prevails in some respectable circles.

§ 2. Stockholders Cannot Nominate.

§ 3. —— Too Many Stockholders.

In saying what we have said, we do not intend to be critical of management that conforms to the existing practice. As a practical matter, little demonstration is needed to prove that a method of selection of directors available to a dozen or more geographically united stockholders, is inapplicable when the stockholders number thousands and have no geographic or social ties—but are united solely by a common ownership of stock in a single corporation. Yet, as we have said, that is today's legal status and it would take a legal genius to conceive a plan that would prove a workable substitute for the modern corporation.

For clarity, as we note from time to time, we are here seeking to define techniques for dealing with the corporation of average size and activity. Here, we need not make our point by resorting to the top line insurance companies with as many as 25 million policyholders or American Telephone and Telegraph with over a million and a quarter stockholders entitled to

vote at an annual meeting for the election of their directors or trustees. Viewing the average corporation suffices to illustrate the futility of expecting stockholders to answer a call to assemble to nominate directors, or to effectively perform that function by the use of the mails. Nor, as stated, does the law make any provision for such a preliminary meeting.

§ 4. —— Stockholders Not Qualified.

Anachronistic though the law admittedly is in clinging to the vestiges of earlier corporate concepts in the face of modern change, here its lag synchronizes with the realities. Public stockholders have neither the time, ability, knowledge nor inclination to assume such a task as selecting directors. Only the exceptional stockholder would be qualified to voice an opinion concerning the personnel or qualifications of directors. As we will see, the task of selection is fraught with difficulty even for those closest to the scene of operations. For the remote stockholder, it is a practical impossibility.

§ 5. —— Stockholder Apathy.

§ 5a. The Average Shareholder Does Not Consider Himself a Co-Owner of the Enterprise.

Here, let us consider for a moment the average stockholder. We can call him a share-owner rather than a stockholder, since that is a better designation of what the law says he should be. But until an issue arises where his interest so dictates, and even when such an issue does arise—he does not consider himself a co-owner of the enterprise, regardless of the rights the

law seeks to award him by virtue of his share ownership. Rather he considers himself an investor or a speculator, an investor who buys his shares for income, or for income and capital appreciation, or a speculator who buys for a market rise. In neither case is he prepared to assume the responsibilities that go with the privileges of ownership, particularly when those responsibilities spell burdens.

If the share-owner is an investor, he retains his stock while he gets his expected income—while things are going well. If he is a speculator, his feeling for the company and the stock is akin to that of the gambler for the roulette wheel that brings him good or bad fortune. In either case, if he suffers disappointment in his choice, he feels that his remedy is to sell and turn elsewhere.

§ 5b. Takes Little Interest.

That the average stockholder lacks the interest of a co-owner of the enterprise, that he prefers to be inactive, that his attention, when given, is casual, admits of ready documentation. Later, in connection with the election of directors, we discuss the reasons for and give examples of the apathy of the average stockholder. Here the subject is of interest merely to demonstrate that even could the law be effectually changed to give stockholders a better opportunity to nominate directors, the attitude of the average shareholder would make it ineffective.

No more cogent examples of the truth of this assertion could be given than those which demonstrate that even when the stockholder's pocketbook is directly affected—and his entry into the corporate world is for

the direct and sole benefit of his pocketbook—the stockholder lacks vigilance and suffers from a lassitude that appears endemic.

§ **5b1. Examples.**

Every corporation of size—and this too may be said not only of our industrial corporations, but of our banks and life insurance companies—has a long list of unpaid dividends awaiting reclamation by delinquent—"lost"—stockholders. For example—and a trifling one —"last year", according to a newspaper announcement, National Products Corporation managed to "find" 258 of its "lost" stockholders; and the company was still searching for 370 more.

This condition is so prevalent, that many states have adopted so-called "escheat" law, providing that dividends, as well as corporations' stock, remaining unclaimed for a period of years shall revert to the state. The Supreme Court has upheld the constitutionality of these laws.

That this condition extends to stock is demonstrated by the fact that in January of 1954, the Securities and Exchange Commission published a pamphlet listing securities of 182 corporations which had been reorganized by the Commission under the Public Utility Holding Company Act and all the securities of which had not yet been exchanged by the security holders. This was part of an effort to prevent these defaulting security holders from losing their property, since time limitations are necessarily set by reorganization decrees, after which former stockholders and bondholders lose their right to exchange.

Another part of this effort is found in the require-

ment of reorganization decrees that periodic advertisements calling security holders' attention to the time limitations be inserted in newspapers most likely to come to their attention.

A corporation, the Tracers Company of America, makes an occupation of seeking to trace delinquent security holders and, from time to time, probably to promote circulation, daily newspapers publish lists of "missing shareholders."

§ 6. Difficulty of Finding Qualified Men.

Good directors need special qualifications, as will be pointed out in detail hereafter. In addition to individual qualifications, they must be such as will enable them to fill particular niches, and thereby produce a cohesive and well-balanced board. And the fit are not always available.

With the exception of a limited number of good all-round men, it is only by chance or as a result of a broad acquaintance, that a qualified man is found available at a given time. This is one of the reasons management, though it wants a board and would prefer outside independent men, turns to its own company executives for board membership.

The better intentioned and more particular the selector, the more difficult it is to select qualified directors. The converse is equally true. One has little difficulty in finding unqualified men who are prepared to lend their names in exchange for the prestige of directorship. And operating men, executives and others in the organization, welcome the accolade of such an appointment.

So too if stock ownership is the only test: An exami-

nation of the stock list is all that is needed to produce candidates. But as the requirements begin to approach proper standards, even management with intimate knowledge of the requirements and the ability to judge prospects, finds the task no easy one.

This being so, how then can remote stockholders, remote not only geographically but in point of knowledge of just what is required, owners of comparatively small proportionate interests, be expected to be in a position to nominate a director? Obviously the answer is "yes," only in rare and exceptional instances.

§ 7. —— **Example.**

To illustrate the difficulty of stockholder selection: A textile corporation had defaulted in the payment of preferred stock dividends, in consequence of which the preferred shareholders became entitled to elect a majority of the board. A group organized to solicit the preferred shareholders for support in naming such a majority. As the defaulted dividends attested, the condition of the company was proving a difficult one since the period was one of depression in the industry.

At this juncture, the principal common stockholder discussed the situation with a representative of the preferred group and said he was prepared to welcome legitimate preferred shareholders of ability to the board and invited the preferred's representative to submit the names of men qualified and willing to serve. After considerable effort, instead of the majority of seven, the preferred group was able to suggest but two men who had the necessary qualifications, and even they were not anxious to serve.

§ 8. Stockholders Can Select.

This is not to say that it is impossible for stockholders to select directors. In certain situations, they do so.

§ 9. —— Strong Stock Group.

Stockholders select directors when there is extant a sufficiently large cohesive and active stockholding group, particularly a group with actual or working control. This is of common occurrence. Management will ordinarily respect the wishes of a large stockholding interest and will afford it representation. It is not ordinarily a requisite that such an individual or group is able to elect a representative to the board, although the ability to do so through cumulative voting is no deterrent.

§ 9a. Example.

An example of this was furnished when the Lackawanna Railroad applied to the Interstate Commerce Commission for permission to put two members on the Board of the New York, Chicago and St. Louis Railroad Company (Nickel Plate), saying it owned 14.8% of the latter's stock and was its largest stockholder. Lackawanna said it sought, not control (which would have violated the Interstate Commerce Commission and Clayton Anti-Trust Acts), but only representation in order to increase the efficiency of joint operating facilities.

§ 10. Proxy Fight.

When stockholders prepare for a proxy fight, they

invariably select their nominees and in such cases, when they are successful, it may truly be said that some stockholders, at least, have selected and nominated directors. On occasion, desirous of gaining general stockholder support for their effort, the contestants are moved to invite nominations from the main body of stockholders. A cogent example of this obeisance to expediency is found in the advertisement inserted by Robert R. Young, in preparation for his contest for control of the New York Central Railroad, which read as follows:

> "Memo to New York Central Stockholders:
>
> If you have any nominations for your new Ownership Board of Directors to be elected May 26, 1952, please advise Robert R. Young and Allan P. Kirby, Alleghany Corporation, Chrysler Building, New York City."

§ 11. Reorganization.

When a corporation emerges from reorganization, the reorganization tribunal usually makes an effort to give stockholders a voice in the selection of a board. The Securities and Exchange Commission, for example, in approving utility company reorganizations, sometimes permits the management to negotiate with stock groups and submit an agreed-upon slate, or calls for stockholder nominations.

§ 12. Management Unwilling That Stockholders Select.

All of the foregoing assumes a complaisant, an acquiescent, or a court-dominated management. In a going concern, while it is conceivable that management

will cater to strong stockholder interests, it is hardly conceivable that it would make a practice of asking the body of stockholders to make nominations.

Generally, management conceives it a management prerogative—indeed a duty—to select directors. Management is as little likely voluntarily to accord this privilege to the main body of stockholders as the political boss would be to ask his voters to tell him whom he should nominate for a congressional seat. Management, like the political boss, subscribes to the latter's slogan: "Let me pick 'em and you can elect them."

Even the most liberal management would hesitate to throw down the bars and invite intrusion by a herd of mavericks. It would be a radical if not a dangerous experiment to do so and one would hardly expect to get a well balanced board of qualified directors in this haphazard fashion.

§ 13. —— Management Wants Control.

But this discussion begs the realities. Management in control wants to retain control, to allocate jobs, to fix salaries and to pass upon other matters of patronage and influence. On occasion, a strong executive's desire to dominate will even be evidenced by the wholesale dismissals or resignations of executive subordinates; for example, the numerous and periodic announced executive changes in Montgomery Ward and Hughes Aircraft. (In the case of Montgomery Ward, once Avery's personal control had been ended, the management rehired executives who had been dismissed by Avery—attesting their competence and the nature of Avery's arbitrary dominance.)

One or more new board members may mean shifting

a balance of power, or a strengthening or lessening of existing control. This political factor, if nothing else, is the prime practical reason for selection of directors by the management or the controlling group behind it.

The selection of officers and directors of social clubs, bar and medical associations, and other similar non-profit associations, offer illuminating comparison. Invariably, nominees are selected by a nominating committee, representative not so much of the general membership but of those individual members who give the needed time and effort to "run" the organization. And here too, the subsidiary facets of the problem are also found, such as the difficulty of finding qualified and available men, spurring the "insiders" to make the selection rather than throw the lists open to the membership.

§ 14. Directors Selected Sporadically.

It is a rare occurrence for an entire new board to be selected. Except in the cases of a new corporation, a reorganization, or as a result of a proxy fight, directors are selected singly to fill vacancies occurring through death, resignation or by increase of board membership. Usually such vacancies occur during the year and the bylaws usually provide that they shall be filled by the board. In such cases, the common practice is for those in control to make the selection. In the process, stockholders or others may be consulted; but, in any event, whoever the selector or selectors may be, the main body of stockholders is not consulted.

§ 15. —— Examples.

Over a short period, the following reports appeared in the daily press:

> "Robert R. Young . . . has formally asked two memberships on the New York Central Board for himself and his long time associate . . .
>
> Mr. White (President of New York Central) told a news conference the question will be brought up at the next Board meeting . . . But, he added Mr. Young has been advised 'that the Board may consider it premature' . . ."
>
> "The New York, New Haven and Hartford Railroad directors appointed a committee of five of its members to recommend to the Board nominees for election as directors at the stockholders meeting . . ."

(A few days later)

> "The management of the New York, New Haven and Hartford Railroad proposed seven new directors yesterday for election to the twenty-one-man board at the annual meeting . . .
>
> Among those left off the slate are the four men in the compromise group added last year to forestall . . . a fight . . ."
>
> "Mr. Dumaine, a Board member (of American Woolen Co.) . . . noted he was asked last June by Mr. White (President) to become a director . . ."

When Alleghany Corporation disposed of its Chesapeake and Ohio Railroad stock, its directors resigned and the remaining directors selected five new men to fill the vacancies.

Pennsylvania Railroad directors proposed an increase of the board by two and selected candidates for election by stockholders for four-year terms.

Similarly, management proposed to increase the American Gas and Electric Company board from nine to twelve and announced that the board would select the three new members.

Upon default in payment of preferred dividends and consequent right of the preferred shareholders to elect two additional directors, the management of Cudahy Packing Company called a special meeting of the preferred shareholders and nominated two directors for the posts.

In the suit brought by the government against duPont, it charged that by reason of its large stockholdings and its representation on the board, duPont had dominated and controlled General Motors for its own benefit. The lower court found that the participation of the duPont representatives in the selection of General Motors directors and in determining the organization of the board did not establish the government's contention. The court said that the record showed consultation and conference but not domination; that Mr. Sloan, chairman of the General Motors board, had clearly been the leader, the dominating influence, and had largely determined the results; that he had suggested the names of directors and had selected the management.

§ 16. Justification for Management Selection.

There can be little practical complaint about management selection of directors when management goes about the problem in a proper way. Given a qualified

and active board, there can be no doubt that management's choice to fill a vacancy will be an equally qualified and active director and there can be no doubt that such a choice will represent a more qualified director than the choice of uninformed random stockholders. Nor should well intentioned management be denied a right to participate in the deliberations leading to selection. And the fact is that in many cases large and active stockholders are consulted. When this is done, it not only makes obeisance to the legal rules but it tends to produce good stockholder relations and qualified directors.

CHAPTER II

Qualifications of Directors—Generally

§ 17. Legal Requirements.

To qualify as a director, various state laws specify varying requirements, including those of age, citizenship and residence. In some states, directors are required to be stockholders, a requirement simply met by nominal stock ownership. In the cases of particular corporations, such as utilities, banks, investment companies, for examples, special state or federal statutes or rules of regulatory bodies, contain added requirements or restrictions. The consequence of these restrictions are "disqualifications" and we refer to these in a later chapter.

§ 18. —— Prescriptions Not Qualifications.

However, legal requirements generally are restrictions rather than statements of affirmative qualifications; indeed viewed negatively, none of the legal requirements satisfy the moral and business qualifications which management and stockholders require for a successful directorate. And it is in the latter sense that we here define "qualifications."

Though, as noted hereafter, the law charges the director with duties, it does not prescribe qualifications for their performance. Instead, it merely calls upon him to exercise his judgment, whatever it may be. Thus the law leaves it to the corporate managers to put smart or stupid, experienced or naïve men on a board. In a word, business, not the law, prescribes the qualifications of directors.

§ 19. Management Attitude.

§ 20. —— Seeking Inactive Directors.

There can be little doubt that many managements, both competent and incompetent ones, feel about directors as they do about stockholders—that they are a necessary evil. So they prefer directors who, like the usual stockholder, will go through the legal motions of performing their appointed tasks without making nuisances of themselves. This management attitude is vestigial of the halcyon twenties, the age of "gilt-edged" corporate securities, when "dummy directors" were the fashion.

As the ward "boss" does not look for an independent, purposeful citizen to run for councilman, so such managements will not seek a director who may exercise an independent judgment and thwart management's will. Instead, it seeks friends, business or social associates or acquaintances, or subordinates, to serve as acquiescent and assenting directors. It is not necessary to have an express agreement with such selectees; it is enough that they know they have been selected by a management that runs the corporation and intends to continue to do so. It takes no effort on the part of a director to be effortless; on the contrary, unless spurred by an active interest, either of stock or ideology, the temptation to be inactive is enough to render a director complaisant. A lack of active curiosity, a feeling that one is serving as an appendage to a business that is management's affair, an unwillingness to be self-assertive; any one of these suffices to make for the type of director a management that seeks an inactive board desires.

§ 21. —— **Big Names.**

One must not be unfair to management that does not consciously seek inactive directors (though it does not consciously seek active ones) but instead makes it a fetich to seek directors whose names will command respect, admiration, prestige and good will. When one goes out looking for "names," one finds himself restricted to a highly successful and perhaps even publicized group of men whose time is so largely spoken for that they can render only the service of bringing the qualities last mentioned to the organization. It may well be that a management would prefer to have these directors active also, to have them devote their undoubted talents to the business, but it must reconcile itself to the fact that it can get one thing or the other, big names or an active interest, and it chooses the former. Many such managements compromise; they get big names for the effect and use executives as the working board members.

The mark of such a board is often a group of corporate presidents, heads of equally large corporations, who hold jobs which obviously take the major portion of their working time and attention. These big named executives are usually in great demand, since many corporations do not permit their top executives to take outside directorships, and those available are sometimes found to be serving on half a dozen large boards, or more.

Back in the twenties, a long list of directorships was a mark of distinction; today, too many of such directors on a board reflect a reactionary cast of management thought.

§ 22. —— Other Reasons.

It is not uncommon for directors to be selected for specific qualifications other than their potentials as working directors, or the prestige of their names. Railroad companies may thus put large shippers on their boards, banks large depositors, industrial companies large customers or suppliers. This area holds a wide variety of motives

Such selections do not condemn a board as inactive if one or more, a minority, are selected as inactive directors. The vice lies in too many directors selected for special reasons who are not expected to be active, or a majority of executives accompanying such a minority.

§ 22a. Example.

In the Temporary Economic Committee investigation in the late thirties, instances of selection of directors by life insurance companies to build good will in remote parts of the country were cited by the investigators; and in some of those cases, an express agreement that the director should not even be expected to attend meetings was the subject of criticism.

In the proxy contest affecting the Minneapolis and St. Louis Railway, the management slate of eleven included five large freight customers.

§ 23. —— Officers and Employees.

When we include officers and employees who serve as board members in the "inactive" category, some variations of phrase are needed. Here we must not be unmindful of the large toes upon which this character-

ization treads. Some of our largest and most successful corporations have boards largely or wholly composed of executives and defend their practice strongly. To apply to such boards the term "Inactive" would certainly be a misnomer.

However, as we point out more fully later, a board composed of executives is not a board in either the legal or actual sense. It is in the nature of an operating committee and, as such, has its place, and an important one, in the corporate scheme. But it is not the board contemplated by the law, or the board which good corporate practice dictates.

§ 24. —— Not Venial Management.

We are not here discussing venal or venial management which seeks hirelings and mercenaries to do its bidding for corrupt or ulterior purposes. Venial management is no more common to the corporate world than the crook is to honest men in the upper strata of society. We are discussing the managements, competent and incompetent, which, in good faith, for an ideological or other reason, "do not believe in directors" and therefore do not seek directors who combine initiative and independence.

§ 25. —— Incompetent Management.

Here we should distinguish between competent and incompetent managements. Incompetent management may not want active and independent directors because it needs them. Defensiveness is symptom of incompetency. Incompetent management fears exposure; it cannot tolerate correction. So it is bound to seek dummy directors and would prefer none at all.

§ 26. —— Small-Minded Management.

The generic term "incompetent" includes the small-minded management, as we employ the latter description. We are all acquainted with the efficient small business man, the man who is capable of building and running a small business in which he supervises and controls every operation, who feels that every expenditure comes out of his own pocket, who is incapable of delegating authority, who, in short, is not an "executive." Such men frequently build a business to a point where it becomes too much for one man, where it becomes a comparatively big business. When a business begins to need organization, division and delegation of responsibility, a sharing in decision, the efficient small business man becomes an inefficient administrator and his management becomes an incompetent one since he cannot take advice from or cooperate with some one of equal or greater stature, i. e., competent members of an active board.

Such management is ordinarily found in the smaller corporation, the family corporation that has emerged from a family business built by the president or his forbear. It is the type of business where the family group is the pool from which the directors emerge, in consequence of which board policies are frequently compounded of dictatorship and family partialities and reactions. These board disabilities necessarily carry into the operating organization and result in nepotism, over-paid and under-working family employees, politics, lack of morale, and similar outcroppings of an underlying unbusinesslike ore.

When a corporate management is so dominated by one man, or by a group of such men, we find an in-

dividual or partnership management that, necessarily yielding to legal compulsions, seeks a complaisant board.

§ 27. —— Entrenched Management.

Unusually entrenched nonstock-holding management does not want an active, independent board, a board representative of stockholders. Our later discussion of what makes and moves entrenched management gainsays any other conclusion. Of course, entrenched management may be competent or incompetent; as an incompetent one, it has found discussion, when competent, it challenges the corporate concept and its challenge merits discussion.

§ 28. —— Competent Management.

There is something to be said for the view of competent management that does not want an active board. It does not want "outsiders" interference for the converse of incompetent management's reason, i. e., because it feels it does not need it. It knows how to do its job and it doesn't want useless assistance.

The successful business mind is a dictatorial one that seeks to minimize and eliminate practical obstructions, not to encourage them. The principles upon which a successful business is run are autocratic, not democratic. The dynamic executive has no patience with democratic delay for discussion and deliberation; when he makes a decision, he wants it translated into action with the least possible interference. His works do not thrive in an atmosphere of debate and deliberation.

The operating man is contemptuous of the outsider's opinion concerning the intricacies and technicalities of

a complicated business. He knows what he knows instinctively, in consequence of long and varied experience, and he has neither the time nor the patience to explain to a half-dozen untutored minds the whys and wherefores of his thinking and action. He is busy with the unavoidable exigencies of everyday business demands and has no time to devote to what he considers legal protocol and obeisance.

One of the board's functions is the practical, business one of being a cog in the operational machinery, like the check and balance gear we find in our democratic political machine. And as we find recurrent clashes between the executive, legislative and judicial departments of our political government, so we find it natural that operating management should resent supervision and control, check and balance, at the hands of a board. So we must expect operating management to seek to ameliorate its rigors. And what better way than by reducing the board to inertia by selection of inert directors.

It is the exceptional man who is prepared to submit to the frequent inconvenience of being overseen and checked, who will voluntarily create an agency that can thwart his will. It is the exceptional man who would be unwilling to risk his own abuse of his own power. Yet that is what is being asked of management that has the power to select its own directors, uninfluenced by any strong stockholder participation or influence. Can management be expected to select voluntarily, to prefer strong dominant and independent men whose views may conflict with management's and who will stand up to management when such clashes develop? The answer is, of course, that the human tend-

ency of management uninfluenced by stockholder pressure is to select a board that will not be over-vigilant or over-assertive.

It is this type of management thinking that we find in many of the largest and most successful corporations; it is this type of management that we find in corporations with boards manned by executives. And it is this type of management, able to point to its commercial, industrial and financial success that, by example, constitutes the greatest obstacle to industry-wide recognition of the ultimate need and value of a strong, active and independent board of directors.

§ 29. —— Management Attitude Short-Sighted.

There are adequate answers to the arguments advanced by such managements, managements that we term "short-sighted." To this epithet, the success of the corporations that are thus managed is no answer; they can be equally and perhaps even more successful by adherence not alone to the letter, but to the spirit and intent of the corporate law.

§ 30. —— Answers.

§ 30a. Legal.

The first argument against this management view is a stuffy legal one, i. e., that the law and the corporate system call for a board and that that requirement is not truly met by a board that does not perform the tasks to which the law entrusts it.

This argument, of course, makes no appeal to the practical-minded executive who wants to get things done and finds himself capable of doing them. His

lawyers will advise him that the mere presence of board members at a board meeting will satisfy the letter of the law and he will be more concerned with his intent than he will be with the law's spirit.

§ 30b. Control.

One of the obvious reasons for this management view is the fear of parting with any modicum of control. When a management firmly entrenched in power takes this view, we find a *force majeure* situation that permits of no argument.

However, such a fear, like most fears, is wholly without basis unless management seeks undiluted and arbitrary control. If management merely wants assurance of its retention of proper and practical control, it can select active and capable directors who will furnish business advice and guidance while recognizing management control and doing nothing to interfere therewith. Though this exercise of directors' functions may not fully satisfy the legal concept, it effects a practical compromise that gives the operating organization the support and cooperation of an active board while leaving basic control where it was—in management—and this usually satisfies the legal and practical requirements and effects the best practical results, as pointed out hereafter.

§ 30c. "Time" Argument.

The practical minded executive will justify his attitude of impatience with an independent board with the argument that an active functioning board involves a waste of time on the part of the operating executives. Implicit in this contention is the conclusion that an

active board is unnecessary, that it contributes nothing to the business operation that cannot be supplied by the operating management. Obviously, if the converse is true, the time required by the presence of an active board is not wasted time. So the nub of the argument is whether a board makes an adequate contribution to the successful functioning of the corporate enterprise.

There can be no doubt that within the corporate scheme, operations are best conducted by the executive who calls the shots and sees that they are carried out. But every large organization .operates in an atmosphere of cooperation, consultation and deliberation. Management committees, operating committees are the mainsprings of every large business. Todays industrial Napoleons are largely the products of associates and subordinates. As the president of a large retail department store told the members of the graduating class of a fashion school: "The day of the table-thumping, imperial, dictatorial boss is gone."

As management committees determine operating policies, so a board should be available to determine corporate policies. As the time spent in coming to decisions in operating committees is not wasted, so the time spent in board meetings is not wasted, if board meetings are properly and intelligently conducted.

The "time" argument has another facet. The big, busy executive says: "When I want to talk a thing over, I want to talk it over. I can't wait a week for a board meeting." This is the excuse for a board composed of subordinates, that they can be gathered together promptly.

Such an executive does not want a board of directors for his "snap" meetings; he wants an operating com-

mittee. Apparently he is putting up to his board matters that he should be discussing with his operating committee.

The need for an emergency meeting of a board is rare. With foresight, the functions of a board can be regulated so that they can be exercised at regular periodic board meetings. Naturally, operating matters need immediate determination—and by insiders—matters of corporate policy require more deliberate and objective judgment—and here the insiders need the benefit of the thought of outsiders.

§ 30d. Secrecy.

An unwillingness to make disclosure leads some managements, particularly those whose companies have grown to be public companies from roots of private and privately controlled ventures, to seek inactive, nonfunctioning boards that will automatically and without inquiry approve management decisions. Here we find the antithesis of the corporate concept for a public company, concealment versus disclosure, a management desire for a supine board, uninformed rather than informed stockholders and their representatives. This is a relic of the rare survival of the practice revealed by the daily papers upon the death of the president of the company still manufacturing Smith Brothers coughdrops, sold in the packages bearing the bearded likenesses of the original Smith Brothers, who, according to the news reports, continued, to the time of his death, the habit of periodically shutting himself off from the world while he secretly mixed the magic brew on which the whiskered fortune was founded. Obviously

there is no place in the modern corporation for practices stemming from that vestigial era.

§ 31. —— Value of an Active Board.

As noted, the "waste of time" argument turns largely on the question of whether an active board is a corporate asset. Enlightened corporate opinion leaves no doubt that duly qualified directors can and should be a valuable asset to a corporate organization for business reasons. They are more than a legal necessity. They draw to an organization skills and knowledge that are not ordinarily possessed by men who have spent their lives and gained their experience within the confines of an operating organization.

The analogy between a competent working board and a service organization is enlightening. In the utility field for example, it has long been the custom to supplement the administrative staff by the engagement of an outside service agency, to provide expert financial and allied service and information not ordinarily available to an operating company through its executives. Small retailers in the drug, grocery and variety goods business take wholesalers' franchises which carry with them the benefits of service and knowledge the large chain store enjoys from its large and highly skilled organization, including its active and working board of directors.

Enlightened management increasingly calls to its aid specialists in every line of endeavor that bears on the efficient functioning of big business, management experts, publicity and advertising men, fashion men, design experts, financial advisers, and a host of others. When such talent can be commanded in an advisory

capacity, for a director's fee, why should management prefer inert figureheads?

Can there be any doubt that a skilled and experienced investment banker is an asset to the board of any corporation that must do financing from time to time? Or that a successful chain store operator can be invaluable on the board of any manufacturing concern selling goods that finds its channels in retail trade?

An astute professional man, lawyer, accountant, banker, an executive, a technician, a manufacturer, a successful man in any commercial or industrial enterprise with active interest in the affairs of a corporation, cannot but be helpful in discussion and deliberation of its affairs, in the determination of its policies, in the conduct of its business.

In a series of studies made by members of the staff of the Division of Research of the Harvard Business School, the conclusion was reached, without qualification, of the need for strong, able directors to meet the dual responsibilities of administration and trusteeship.

A man who has been born blind learns to thrive without his eyesight; he cannot fully appreciate the loss of what he has never had. So with many of our corporate enterprises which have never had the benefit of an active, working board of directors.

It is the nub of the contention here made that management seeking board members should seek men of the highest qualifications, since a board so constituted will be found of value to the management and the corporation, that it can readily be moulded into the organization as a practical working tool, that it need not be feared by management, nor deemed "useless." If such a board is found to be "useless," the fault will lie with

management, either for failure to seek qualified men, for failure to encourage them to be active or for obstructing their efforts to function efficiently.

§ 32. Qualifications.

§ 33. —— Inactive Director.

As management that seeks an inactive board is not necessarily venal or incompetent, as it may proceed on the basis of a mistaken corporate ideology, so the inactive director will ordinarily be the well-meaning and complaisant one. He shares the management concept of management dominance. Having been selected by management, he feels his duty and loyalty runs to management. His notion is that any obligation to stockholders rests not on him but on management; that it and not he represents the main body of shareholders.

The incentive to the inactive director is friendship, or he may feel the post carries with it prestige and repute. Thus his acceptance may be a favor to management, or he may feel that he is being favored.

The "dummy" director may be a nobody; the inactive director may be a man of affairs, a person of character and integrity. No generalization can be made.

§ 34. —— Active Director.

Conversely, if a man of repute and experience is prepared to be independent and inquiring, if he is conscious of the responsibilities he personally assumes and undertakes their performance in a practical and cooperative way, he can make a definite contribution to the corporation and its stockholders and convert even an unwilling management to an understanding of the value of an active directorate.

An active board is no place for mental superannuates. Besides the necessary physical vigor and competence, first of all, the qualified director must have independence. He must be free and without ties that prevent him from exercising his fiduciary obligations to the corporation and the stockholders he serves. He must have the courage to curb rapacious or incompetent management. He must have the discrimination to lend honest, detached and observant judgment to the efforts of honest and competent management. He must be prepared to give the necessary time and effort to the performance of his duties. He must be mindful of their scope, while being conscious of the prerogatives of management. He must be open-minded, intelligent, patient and cooperative.

Temperament is important. The active director must be strong enough to be courageous and independent. But he must not be so dominating as to prove uncooperative. The board must work as a whole, not as an appendage to any one man, be he director or executive. At the same time, the director who has individual qualifications beyond the average, experience, skill, contacts, prestige, can be of inestimable value to the enterprise in a variety of individual ways.

§ 34a. Particular Qualifications.

These brief generalities deserve elaboration and documentation. Elsewhere, in discussing directors' conduct at meetings, we view some of the qualities, pro and con, which make for successful or unsuccessful administration. Here we comment respecting individual characteristics that make for an effective or an ineffectual director.

§ 34a1. Independence.

Take the quality of independence to which we have adverted. Since the word connotes self-assertion that is too frequently an expression of defensiveness, it is better explained by resort to negatives. So expressed, it means a director who is not prepared to curry favor with management to keep his job or otherwise to become the recipient of managerial favor. It excludes the close friend whom the executive has invited to the board and who will not jeopardize their friendship by needed dissent. It means the director who has such faith in his value to the business that he can speak as he believes and act as he feels the situation requires. It means the man who is confident that he can gain respect by being honest with himself and others and is willing to pay the price when others prove themselves unworthy of such treatment. It spells the man who knows that expediency leads to expediency and winds up as dishonesty.

The independent director is not the obstinate, nor is he the uncompromising one. He is not the biased promoter of ideas, the sponsor of prejudices, of preconceived notions, of exploded and discredited theories. He is the man who will go along with management when he feels it is entitled to support, who will not hesitate to challenge management's views when he feels it is wrong. Nor is he the noncompromisor who stands on "principle"; he is sufficiently open-minded to know that the whites and blacks are rare; that most situations are shot with grey.

Finally, he is the director who, when the issue is not so important or decisive as to require maintenance of

an issue, will yield to management's desire and recommendation.

§ 34a2. Inquiring Director.

The inquiring director is the courageous director, the curious director. He has the courage to admit that, though perhaps he should, he does not remember or understand. He is the curious director who will not yield to the lure of the tide until he knows whence it comes and where it is going to take him. He has the courage, too, to resist it and to disturb the even tenor of its way, despite an impatient chairman and acquiescent majority.

This is not the man who, by questioning, seeks to assert himself, to make himself important, but the man who seeks needed information.

A competent and experienced management, in presenting a proposal, will ordinarily supply all relevant information. But such information invariably involves technicalities and is based on established business practices with which the management is far more familiar than are the directors. The director asking for needed information will find that he is seeking facts which his fellow board members and ofttimes the management also need. He will also discover that competent management also prefers that its presentation be made clear and adequate so that directors may know what is involved, since their informed judgment buttresses that of management and gives it assurance that its conclusions are justified.

§ 34a2.1. Examples.

Management recommended the extension of a lease;

when a director made inquiry of the reason, he was told that the original lease had been made 50 years before and had been extended periodically by prior managements and directors. The inquiring director pressed for a statement of the purposes, the necessities, the advantages and disadvantages of a renewal of the lease. It immediately became apparent that management had little familiarity with these details; it had concluded that the lease should be renewed simply because it had always been renewed. The consequence was a thorough inquiry which resulted in management conclusion that substantial and beneficial modifications should be made.

Again: Management suggested an authorization to sell real property, no longer needed, which it recommended because the price exceeded an appraisal. It appeared however that a portion of the purchase price was to be paid in annual installments.

Thereupon an inquiring director asked: What interest is to be paid on the deferred payments? The answer was that a 3% rate had been arranged. Thereupon, the director pointed out that if the deferred payments were discounted, the net immediate cash price would be less than the appraised value.

§ 34a2.2. Reactions Informative.

The attitude of management when questions are asked is helpful in enabling directors to estimate the capacities and tendencies of management. Questioning will often lead to suggestions, to information that opens new fields of inquiry and investigation. It may reveal management defects and lapses or provide clues to betterment.

§ 34a2.2(1). Example.

A management recommended forgiveness of a portion of a debt owing from a corporation, saying that its balance sheet showed its inability to pay in full. An inquiring director asked if inquiry had been made of the identity of its other creditors. He was told that a substantial portion of the indebtedness was owing the corporation's principal sponsor and stockholder. Further questioning disclosed that instead of providing the initial corporate capital through subscriptions to the capital stock, the sponsor had advanced a substantial portion of the capital as a loan and it was the existence of this loan that created the insolvency.

It so happened that on the agenda for consideration at the meeting was a proposal to organize a subsidiary corporation and the management had proposed that the corporate investment of half a million dollars should be represented by capital stock subscription. Thereupon, the inquiring director asked why the corporation should not limit its stock subscription to $100,000 and advance the balance as a loan, thus reducing the risk. With the previous discussion fresh in its mind, the management altered its proposal accordingly.

Again: An inquiring director asked why the annual amortizations of a bank loan were so heavy they constituted a drain on the company's cash position. The answer was that the loan had been contracted three years before, on a 5-year basis, when the company's condition was not as good as it subsequently came to be. Thereupon, the director asked why the loan, at its existing level, could not be renegotiated on a 5-year basis. The president seized upon the suggestion; the

loan was extended and the amortization payments reduced accordingly.

§ 34a2.3. Stimulates Board.

One director's habit of questioning will frequently stimulate like habits in other directors, with consequent improvement in the attitude of management and the entire board.

§ 34a2.3(1). Example.

A director went on the board of a well known and long established company. He soon found the meetings boring and unproductive, the majority of the board tended to await management's recommendations and blindly support them. His questions found management defensive and resentful, his fellow directors scornful. In time, however, by questioning, he was able to lay bare management's lack of information and lack of preparation of proposals presented, due largely to management carelessness caused by board apathy and blind acquiescence. After the questioner had scored a few times, the other board members began to become interested, gradually they too became mildly critical of management's presentations. Stimulated by the changing attitude of its support, management began to frame its proposals with greater care and began to welcome board cooperation. The change of attitude of management and the board was a gradual and almost indiscernible one but the inquiring minority director a year or so later, was able to remark truthfully:

> "These meetings aren't dead anymore; everyone's on his toes; management is alert to the need

of justifying its proposals and the board members enjoy taking them apart; everybody's alive and enjoying the meetings."

§ 34a2.4. Inquiry Should Not Be Unfair.

Asking questions should not be a means of voicing suspicions, implying criticisms or otherwise attacking management. Questions should not constitute cross-examination; they should not be "loaded" ones, or otherwise unfair. Where the questioner knows the answer to his question and it reflects on management, it is better asked in private, unless management is uncooperative or antagonistic. The purpose of questioning is not to discredit management or to make it defensive; its primary purpose is to inform directors, its secondary purpose may be to inform management. Competency and awareness are what directors seek in management.

There are competent managements who need no prodding, no questions, no searching scrutinies. Here the questioner may be valuable only for the primary purpose of informing himself and the other directors so that they may not act with blind confidence in even the best of managements.

§ 34a2.5. Questions Should Not Be Speeches.

It should be remarked that a distinction must be observed between a relevant questioner and a garrulous director. The satisfactory and qualified director is not necessarily the brash, venturesome or talkative one. Every experienced director has encountered the endless talker on the board whose irrelevancies ofttimes

drive the board to an insufficiently deliberated vote or a later train. And it appears that even a director may not only talk too much, but he may talk too well.

§ **34a2.5(1). Example.**

So, reported an article in the New York Times, headed: "Eloquence Proved a Bar to Kettering; Sloan, at duPont Trial, says Inventor's Volubility Kept Him Off G. M. Policy Unit". The following news article said, in part: "Charles F. Kettering . . . was kept off the company's policy committee because he talked too well and too much . . . Mr. Sloan said . . . other directors agreed that Mr. Kettering . . . should not be put on the committee; . . . they had feared Mr. Kettering would so enthrall the other committee members with his comments about the wonders of the future that 'we wouldn't have time to tend to the business of the corporation' . . . 'through his personality and the interest that he can always develop, the meetings become one of listening rather than one of doing business'."

§ **34a2.6. Moderation Needed.**

It must be noted too that a well-balanced board calls for a minimum of questioners. The usefulness of a director is in proportion to his talents and their employment. A board wholly composed of questioners would make a shambles of a meeting. They also serve who sit and listen.

§ **34a3. Persistence.**

We have indicated that, on occasion, a questioner must be persistent. But persistence is not to be nar-

rowly construed as requiring only a follow-up of questions, however necessary that may be in the probing process. Penetrating the skin is not enough if a surgical operation is necessary. Persistence requires more assiduous follow-up; to leave an explored situation undetermined with an unwilling management is of little benefit, although with a willing, competent and cooperative management, a director need do little more than aid in opening its eyes to the possibilities. Where occasion requires, follow-ups may be called for when a matter has been left unfinished at a prior meeting.

§ 34a3.1. Example.

An example of rewarding persistence was furnished by a director of a textile concern who periodically called attention to the competition being suffered from knitted articles which could be produced more cheaply than the woven product of the company. It took several years of persistent effort but finally management was persuaded to expand into the knitted field, not only with consequent profit but with the ability to hold its customers who sought to substitute the knitted for the more expensive woven article.

Another example of rewarded persistence was to be found in the case of a coal company that had been losing money on deep mining and was continuing to invest money in removing overburden from its stripping operations. Over a period of years, a director persisted in referring to the problems periodically, finally, operations were modified to effect results in both situations. It should be added, in fairness to management, that in the one case labor problems were alleviated meanwhile; in the other industry conditions changed for the worse

and moved management to a changed and more co-operative attitude. But, in any event, the persistence had continued and ultimately paid off.

§ 34a4. Assiduity.

It is undeniable that perspiration produces more result in this world than does inspiration. The persistent director is also the assiduous one. A director who seeks to take a position on a controversial subject which is about to come up at a meeting, like competent management making a proposal to be effective, should obtain and marshal his facts and prepare his argument.

§ 34a4.1. Example.

In the case previously mentioned of the textile company, during the period in which the company was experimenting with the knitted article (a period during which, at the outset, it was conceded that a break-even would be a favorable result), a vice-president proposed that the knitting plant be sold and the experiment abandoned; that instead the company acquire a lace plant offered for sale. At the meeting, the vice-president who was a director, and three other directors, a majority, expressed their assent; whereupon the persistent director charged that each was advocating sale of the knitting venture, only in order to have funds and working capital available to buy and operate the lace plant. Each denied the charge, asserting that he was of the opinion that the knitting operation would be unprofitable. Whereupon, the assiduous director not only produced the minutes of the original meeting wherein each had expressed the opinion that if the experimental plant broke even, it would prove the venture profitable,

but the figures of operation, showing a small increasing profit, as the technique of operation was acquired by the working force. Then he produced letters and memoranda written separately by each of the four directors prior to the suggestion of acquisition of the lace plant, unequivocally stating their opinions that the knitting operation was and would prove to be a profitable one. Needless to add, the knitting business was not sold.

§ 34a5. Outside Aid.

Situations arise where, however diligent a director may be, the problem posed is beyond the scope of his knowledge. Such situations are not infrequent when a technical question arises, when management's reply to a director's suggestion involves some operating or technical difficulty beyond the director's technical grasp. Then, the director may be compelled to seek outside technical aid, and the assiduous director who feels he is right and that management may be mistaken will not stop short of seeking such assistance.

§ 34a5.1. Examples.

The directors of a large merchandising concern were dissatisfied with many features of the OPA pricing program and its administration. It undertook to summarize these objections and make suggestions for remedy and this it purposed distributing to trade associations and political representatives. A half-dozen drafts were submitted to the board, drawn in turn by the company, executives, counsel, and public relations men. The board was unable to agree that any of them met the purpose. A director who had sat in on

the meetings and who had read the various submissions and who had had the benefit of hearing the other directors' varying opinions thereon, spent the better part of a week in drafting and redrafting a memorandum which incorporated the various suggestions of the board members and eliminated the sources of their objections. Then he had his own lawyer conform it properly to meet and overcome the legal angles posed by the OPA regulations. It met with the unanimous approval of the board and was thereafter effectively used by the company.

Again: In the course of a discussion of dividend policy, questions as to the practice of other companies in the industry concerning retained earnings and rates of yields arose. A director challenged the opinion of management upon which management was basing its recommendation. Lacking agreement, the board adjourned to a subsequent date. The doubting director had the statistical department of a brokerage house compile the necessary information for him and when he presented it at the subsequent meeting, management accepted his figures and revised its recommendation.

§ 34a6. Moderation Needed.

But a director should not be diligent to the point of becoming a meddler or a nuisance. Above all he must remember that whatever he wants done officially must be done by the board; that overt individual action on his part (in his capacity as a director of the company) is neither permissible nor justified. So he must not write letters to the newspapers or make public statements affecting the company or its industry. And

he must not infringe upon the provinces of the executives.

§ 34a6.1. Examples.

A new and over assiduous director, anxious to adequately inform himself, undertook to devote one day each week to visiting the plants of the company so as to familiarize himself with its physical assets and operations. Immediately, objection poured into headquarters; employees complained about being spied upon; managers complained of interference; and chaos resulted.

CHAPTER III

QUALIFICATIONS OF DIRECTORS—SPECIFIC AND SPECIAL

§ 35. Stockholder.

§ 36. —— Legal Provisions.

By requiring directors to be stockholders, some state and federal statutes have indicated their opinions not only of the value but of the necessity of stock ownership by a director. Though in practical operation, this

requirement has been negated by the practice of acquiring title to "qualifying" shares, the weight of the legislative opinion still remains.

§ 37. —— Should a Director Be a Stockholder.

The argument is often heard that a man should not be elected a director simply because he is a stockholder. Of course, so slanted, the argument is valid, just as good as the argument that a man should not be appointed to a political post simply because he is a Republican, or a Democrat. But in the one case, as in the other, the fact that a man is a stockholder, or a member of the political party in power, is additional and just reason why, if otherwise qualified, he should be appointed.

Whatever may be the reason urged for the selection of a particular director, one thing must be borne in mind, i. e., that the purpose of electing a board is to select a body that will function efficiently for the advancement of the corporate good; consequently, no consideration of special interest such as stockholdings alone justifies the selection of a director who will not further that purpose.

Certainly, as between two men of equal qualifications, preference should be given the stockholder; indeed, stockholdings may be a qualification that should weight the scales against a somewhat better man.

§ 37a. Example.

In the reorganization of a company, a committee representing preferred shareholders who had received shares of another company in exchange for their preferred shares, was given the privilege of naming a di-

rector of the new company. The committee named its chairman, an experienced director. However, before the appointment was finally confirmed, the chairman learned that the bulk of the committee's depositors had sold their stock in the new company to other interests. These other interests were also desirous of naming a director of the new company. Thereupon, on learning the facts, the chairman withdrew his name and nomination as a director, saying he felt that the purpose of the reorganization would be better served if the new purchasers, now stockholders, were represented in place of the chairman, the representative of depositors who had largely disposed of their stock.

§ 38. —— Stockholder Is a Share-Owner.

In the eyes of the law, though, as previously noted, he may not so consider himself, the stockholder is a share-owner of the enterprise, a co-proprietor. The law contemplates that he will select its managers, its directors. What is more logical than that he should be one of them?

Primarily, a corporate enterprise is operated for the benefit and advantage of its stockholders. There should be no one with greater devotion to this task than a stockholder; there should be no one who should better represent himself and those similarly situated, i. e., his fellow stockholders. Conversely, there is no one in whom stockholders should have greater trust and confidence than one of the co-owners of the enterprise.

§ 39. —— Has Incentive.

One of our corporate problems is that of finding sufficient incentive to good men to serve as directors.

The director who has a substantial stake in the enterprise furnishes a convincing answer to the dilemma of finding an incentive to induce a competent man to serve. A substantial stockholder's motive in giving the director's job the time and energy it requires, cannot be questioned.

The man who is actuated by the profit motive takes a different and more serious view of the corporate problems than does the director, however conscientious, who lacks that spur. In isolated situations, a director who owns no stock may be needed to be dispassionate and objective in a factional dispute between majority and minority stockholders, or respecting dividend policy between large and small stockholders. But these occasions are rare.

§ 40. —— Is Stock-Minded.

One of the incentives for investment in stock is the stability and appreciation of the investment as reflected in the market price of the stock. So, it is of importance to stockholders that management be stock-minded. And, obviously, no director should be more stock-minded than the stockholder himself.

In the past, a school of management thought opposed management and employee stock ownership; the theory being that officers and employees should be interested only in the company business; that their attention should not be diverted to "stock speculation." The extension of this thought was that company management had and should have no concern with the market prices or "gyrations" of the company's stock.

The answer to this old-fashioned management notion will be found in our later discussion of stock-

holder good will, which, summarized for this purpose, holds that management must be stock-minded so it may do what is needed to enable the company's stock to enjoy an adequate market.

Here we need only point to the recognition being given, through the medium of executive and employees stock option plans, to the value of having stock-minded executives and employees, to refute the anachronistic argument based on the old concept of the stock market as a place to gamble.

§ 41. —— Stockholder Good Will.

One of the facets of successful corporate operation is stockholders' good will. Stockholders tend to gain in confidence when they feel they are represented, not solely by management seeking its own operational compensations, but by directors, who like themselves are stockholders seeking dividends and capital appreciation. When conditions become unfavorable, stockholders are less apt to be critical of management when stockholder-directors champion management's cause.

The director-stockholder is available for something more than stockholder good will. He is a means of securing active stockholder cooperation, something many corporations seek in a diversity of ways. He is available as a conduit between large stockholder groups and managements, between brokerage houses available to recommend the stock and the management. We discuss and illustrate this later in our discussion of stockholder good will.

Today's tendency encourages director stock-ownership. When candidates are presented for election as

directors in a proxy fight, they are invariably stockholders.

The slate offered by Robert Young in the successful New York Central fight comprised 15 nominees holding an aggregate of more than one million shares. Every nominee was a shareholder. In the New Haven contest, the eight persons who signed the original letter challenging the displaced management described seven as stockholders and one as the president of a company holding a considerable amount of stock.

A distinction might here be made, occasioned by the announcement of a controlling stock interest that it expected all its corporate officers to be stockholders. It is, of course, desirable that executives' and employees' corporate interest be advanced by stock ownership. The prevalence of stock option and bonus plans attest this. But an officer does not voluntarily undertake, as does the director, to represent the shareholder. Officers do not formulate, they mercy execute policies. Stockholdings with them may be an incentive; with the director it is part of the stockholders' stake with which he plays.

§ 42. —— Large Stockholder.

There are occasions when a large personal stockholding may impair the general usefulness of a director. Since a director is essentially the representative of the main body of the stockholders, he is most valuable when he can think and act as they would. Accordingly, the best qualified stockholder to serve as a director is one whose holdings are representative of the average outstanding.

The large stockholder director's attitude on divi-

dends is apt to reflect his higher tax bracket rather than the common desire of the small stockholder for more income. On occasion, the large stockholder-director may be unwilling to have the corporation take calculated business risks because of his large personal share of a potential loss.

More common than the individual is the group that has a large financial investment in a company and is represented on the board. Here the director is not wholly a free agent, but must serve the particular and undisclosed purposes of his employer. Thus this situation also falls into the "special interest" category which we discuss hereafter.

§ 43. Special Interest Groups.

§ 44. —— Stockholders.

Such disqualifications as the representative of a large stockholding group brings to the board are inherent in the corporate scheme. As in the case of any special interest represented on the board the director is an agent, and ordinarily an agent is not free to think and act, as a director should be. The large stockholding disability ranges from the exercise of control against the interests of the minority, to the influence of a strong stock holding with an ulterior motive. In such case the director may be a repository of conflicting loyalties. In a rare instance, the clash of interest may even justify legal intervention.

§ 44a. Example.

One such extreme was to be found in the suit brought by the Hamilton Watch Company against the Benrus

Watch Company to enjoin Benrus from voting the 24% of the Hamilton stock it had purchased and thereby put a director on the Hamilton board. The court granted the injunction, holding that the effect of giving Benrus representation on the Hamilton board would impair the latter's competitive position.

A former vice-president of the American Investment Company of Illinois who became president of a competing company urged stockholders of American to adopt cumulative voting. The management of American successfully opposed, contending that the former vice-president sought, through cumulative voting, to gain representation on American's board so that he might gain "access to the company's plans."

In the Montgomery Ward contest, the management charged that Wolfson and other opposition nominees were directors of companies that competed with Montgomery Ward and that, in consequence, their election would violate antitrust laws. To avoid possible disqualification, the nominees resigned as directors of the alleged competing companies.

A proposal to elect the chairman of the Reichhold Chemicals a director of Catalin Corporation was rejected by the board of Catalin "for the reason, among other things, that section 8 of the Clayton Act prohibits interlocking directorates of competing companies."

§ 45. —— Others.

From time to time, special interest groups, consumers, labor, public, claim the right to be represented on corporate boards. Labor unions clamor annually for representation on the boards of some companies, a

clamor that has no chance of finding fruition but which apparently is dictated by propaganda tactics.

The arguments for such representation are negligible and usually palpable in their dishonesty. Generally, they are twofold: (1) the special interest wants the opportunity to express its views to the board; and (2) directors should represent not only stockholders, but other interests, management, employees, the general public, etc.

The answers are clear. As to the first contention: Obviously, there is no need of giving a special interest group a place on a corporate board for the purpose of putting its views before the board. That can be done with greater propriety when the special interest group is an outside interest.

As to the second: Since "represent" means "to serve with delegated or deputed powers," and the stockholders, as the owners of the company, elect the directors and delegate authority to them, necessarily, it is the shareholders whom they represent. While the directors, as representatives of the stockholders, must recognize and fulfill the latter's obligations to special interests, management, labor, consumers and the community, it would be anomalous for the special interest to be able not only to plead its case but to judge it.

§ 45a. Example.

The classic example of a special interest group—labor seeking representation on a board—occurs periodically when employee-stockholders of the American Telephone and Telegraph Company seek to nominate and elect directors of their own selection to the board. On one of these occasions, the union took court pro-

ceedings in an effort to stay the annual meeting because the management refused to submit a union proposal to the stockholders for a vote. On another occasion, the employees were publicly seeking a pay increase and threatening a strike. The concurrence of these two attempts furnished striking example of the discord success of such an effort would create. And the practically unanimous adverse reaction of stockholders testifies not only to the efficacy of the management's proxy machinery, but, in this case at least we are entitled to believe, it expressed indignant ownership opinion and reaction.

The potentialities of confusion and conflict of interest lurking in such situations was revealed in the course of the Montgomery Ward proxy contest when it was disclosed that the Teamsters Union owned 26,000 shares of Montgomery Ward stock for which both sides would naturally seek proxies, while it was currently in negotiation with management and threatening a strike.

Following the war, labor in Germany obtained legislation giving it substantial representation on company boards. According to a 1955 survey by the Wall Street Journal, the experiment did not seem to have worked out satisfactorily, either for labor or for management, for a variety of reasons.

§ 46. Executives.

A subject of pro and con opinion is posed by the question: Should executives—salaried employees—of the corporation serve as directors?

§ 47. —— Individual.

The president is and, of course, should be a mem-

ber of the board. The presence of some additional executives, while not objectionable, carries no particular advantage.

The reasons given for executive service are that the executive is readily available for meetings, has greater familiarity with the business and is available as an expert technician. Frequently, the real reason is the inability to find or the unwillingness to seek a suitable outsider.

The cons of these arguments are these:

There should be no need for hurried board meetings. We have discussed this previously.

The president is available as an expert; if he is not, the other executives should be and ordinarily are available, without being board members.

The executive is not needed on the board to express management viewpoint. The president should do that.

The principal vice of the executive on the board lies in the fact that board decision should be influenced by management opinion; the decision itself should not be management's vote.

The subordinate executive has greater disadvantages as a board member. He is not a free agent, management politics will dictate his vote; if it does not, management controversy and rifts may be encouraged. Either way, troublesome potentials exist.

§ 48. —— Retired Executives.

A retired executive, who is temperamentally qualified, should make an excellent director. He has the executive's knowledge and skill while he lacks the disadvantage of dependence or subordination.

We say elsewhere that a director should not be su-

perannuated. Retirement age, in this day of forced retirement to make way for younger men, is no sign of superannuation. A directorship furnishes opportunity for continued mental activity, an antidote to sudden cessation of habitual activity. A retired executive will have time to devote to the requirements of the post; he should be eager and grateful for the opportunity to serve.

§ 48a. Example.

An example of the principle advocated in the foregoing text was furnished when Governor Dewey of New York selected a former vice-president of the New York Telephone Company, a man of 63, to head the State Civil Service Commission. Though the appointee was earning $60,000 per annum at the job from which he would have had to retire at the age of 65, he accepted the new post which paid less than $20,000 a year.

§ 49. —— Many Executives on the Board.

Despite the fact that some of our largest and most successful corporations have boards composed largely or entirely of executives and, as noted previously, advocate and defend the practice, it cannot be gainsaid that it challenges the basic democratic corporate concept. The stockholders, as owners of the enterprise, are entitled to be represented by directors who will be the managers of the enterprise. They are entitled to have officers appointed by and subordinate to the directors. The fact that stockholders do not select directors, that they elect them automatically—these still leave the stockholders with a measure of potential protection when outsiders man the board. When, however, the

executives themselves constitute the board, there is no board except in form. Such a board is nothing more than a top management committee.

Every large corporation needs and should have a top management committee. It is an integral spoke in the operating wheel; it is not an *alter ego* for a board of directors. Its members think and act like management; they cannot think and act like directors.

An executive-dominated board cannot supervise the executives, which is one of the top functions of a board of outsiders. It can only supervise itself; a Pooh-Bah arrangement, as another writer has said, worthy of Gilbert and Sullivan. It is not what a board must be—representative of the stockholders, and a check on management.

Such a board rends the stockholders' second line of defense as completely as does a "dummy board." In truth, the latter holds out potentiality of reform; the former leaves the stockholders completely at the mercy of management.

When we discuss the true functions of a board, the vulnerability of executive-dominated boards becomes even clearer.

§ 49a. Example.

In the duPont-General Motors antitrust suit, the federal attorneys contended that duPont, through its large General Motors stock ownership, had elected directors and through them, had controlled the policies of General Motors to favor duPont. The defendants contended that duPont had never named more than a minority of the General Motors directors; the government attorneys replied that this minority in fact con-

stituted a majority of the General Motors directors who were not General Motors operating men, thereby making the contention that operating men were in fact but nominal directors.

§ 50. Technicians and Experts.

§ 51. —— Generally.

Assuming the candidates otherwise qualified, we ask the questions: Is it desirable to have a lawyer on the board? a banker? an engineer? a technician skilled in the industry? a public relations expert? etc., etc.

The general answer is that the purpose of a board is best served when it collects for the benefit of management a group of outside-of-management capable minds, trained and experienced in fields not available to management. Such a well balanced board will include experts in various fields into which the corporate interests range. In the larger corporation, the most ubiquitous of these will be the lawyer and the investment banker. Others may include accountants, publicity and insurance men, management experts, business executives in other fields.

§ 52. —— Particular Functions.

Such skilled men, of course, are invaluable on occasions; the investment banker when corporate financing is to be done or when the company's funds are to be placed in temporary or semi-permanent investments. Similarly, the accountant is available for constantly recurring tax problems and it might be noted, in passing, that hardly any major corporate problem does not turn upon or its disposition is not affected by tax questions.

An insurance man on the board can and will protect the company in its dealings with insurance agents and insurers, keep it from wasting money on uncollectible over-insurance or needless risks, on apparent but not actual coverage and in a diversity of other ways not discernible to the nonexpert.

It is almost supererogatory to point out the value of a lawyer's slant on corporate questions.

The presence on the board of experts skilled in allied fields can be, at times, of inestimable value.

§ 52a. Examples.

For analogy, the RFC "fell down in its first attempt at selling a $65 million issue of B. & O. railroad bonds." It received a single insufficient bid simply because "an official circular describing the bonds had not been furnished for dissemination sufficiently ahead of the bidding deadline." In private financing, any experienced director banker would have avoided this *contretemps.*

An example of a lawyer on a board furnishes an equally informative instance. The board was called on to approve an agreement with a trustee designated to hold stocks purchased by an investment committee of the board. The agreement had been read and approved by trust company and company counsel, had passed the management and was about to pass the board when a lawyer member pointed out that although the agreement described the powers to be exercised subject to the direction of the committee, it failed to say the trust company *should* exercise them when and as the committee directed. The omission was obvious once it had

been pointed out; before that it had lurked unseen like the hidden figure in a picture puzzle.

§ 53. —— Technician in the Trade.

The advantages referred to respecting technical men in allied trades as directors would not seem to include a man skilled in the particular trade in which the company is engaged. Aside from the difficulty of getting a man skilled in the particular industry who may not have a conflicting interest as competitor, contractor or customer, the tendency of the presence of such a man on the board may unduly influence or interfere with management, or awaken management resentment or defensiveness.

Where management is competent, all needed technical information should be available to the board and the presence on the board of an outside technician would seem to be disadvantageous.

Where directors lack confidence in the technical skill or the integrity of management, the presence of an outside technician on the board may serve a useful purpose. But the need for such a temporary expedient calls for more drastic remedies if directors cannot rely on the honesty or ability of management.

§ 54. —— Caution.

An expert must not be permitted to dominate the board. Business judgment must not be overpowered by legal dogma or, more possible, by legal over-caution. A board must continue to function dynamically; the conservatism of lawyers or of investment bankers must not become a retarding influence.

A technician's slant on a problem is helpful and may

become persuasive with other members of the board. It should not be permitted to become a substitute for deliberation and judgment on the part of the nontechnical members of the board.

A lawyer-member's opinion on a legal question is not a substitute for the opinion of company counsel and should not be so considered. A banker-member's opinion on a method of financing to be adopted does not afford a substitute for an outside expert's opinion, sought and paid for. Nor does the former offer the protection that the latter affords a board.

When a competent outside expert's opinion is sought and is paid for, it must be assumed that it is based upon adequate study of the problem and of all its phases. An expert on the board may or may not have given the subject adequate study and consideration. His judgment may be a snap one.

Then, too, it must not be overlooked that the average professional man on the board either has, or may ultimately expect to have, personally profitable business relations with the corporation. Such actual or prospective business relations may color the expert's opinion.

§ 55. Women.

Within recent years, there has been agitation to put women on boards. It is manifest that some of these efforts are part of publicity and propaganda efforts. Nevertheless motives, even if meretricious, should not be permitted to detract from the soundness of a cause.

It is difficult to see why, in this age of emancipation of women, this should be a topic of discussion. Ordinarily, sex should be neither a qualification nor a dis-

qualification for membership on a board. If a qualified woman is suggested for membership on a board, there should be no occasion for rejecting her by reason of her sex. There can be no doubt that a woman's participation in board deliberations is valuable where the corporation's business takes it into fields where the feminine viewpoint is important. Cosmetic, ladies apparel and similar businesses would gain from having the feminine point of view expressed at board meetings. On the other hand, insistence upon feminine representation on a board solely because women are shareholders finds no more justification than would insistence upon a red-headed director to represent red-headed stockholders.

§ 56. Business-Getting and Nonresident Directors.

The selection of a director for a special reason, the ability to influence deposits in a bank, the need for prestige of an oil company's foreign manager, finds practical justification.

A Fortune article told how Otis and Westinghouse directors played active parts in seeking the valuable elevator installation contracts for the new Socony Vacuum building on East 42nd Street, New York City.

But the fulfillment of such a purpose alone does not constitute a qualification for the director. A minority of such directors is tolerable; a majority results in an inactive board.

§ 57. Professional Director.

The term "professional director" has been defined by the English practice of naming peers to boards for the purpose of inducing investor confidence. The re-

sults have not been such as to warrant confidence in the professional director.

In this country, during the twenties, we had what, in effect, constituted a professional director class, a number of gentlemen of good name and prestige who accepted inactive posts in exchange for opportunities to profit in the securities of their companies. Some vestiges of that practice remain, though the perquisites no longer exist.

Presently, almost indiscernibly, in consequence of the large concentrated interests of investment companies and banking houses, a class of bright and skilled corporate executives and directors is growing, men, graduates of business and law schools, whose services are availed of by financial houses interested in various corporate enterprises. Except as these designees must serve the special interests of their sponsors, they constitute highly qualified directors and might well constitute a professional solution for some of the deficiencies in the present system.

As pointed out earlier, the retired or semi-retired man of means, who has investments in various corporations and is otherwise qualified, may well serve as a director; and his directorships may become so numerous and he, as a result, may become so skilled, that he might be termed a professional director. Given a sufficient number of such men, we might witness the genesis of a group of professional directors, for limited service, however.

The vice of the professional directorship comes when the director is "hired" by management in lieu of undertaking service at the instance of the stockholders he

should represent. In that difference, lies disqualification versus qualification.

The obituary of a 66-year-old partner of a New York banking investment house disclosed him to be what might be termed a professional director. The notice revealed that at the time of his death he was a member of the executive committee and a director of six large companies, a director and chairman of the executive committees of five others and that he had been an officer or director of four other major companies.

§ 58. Public Director.

The subject of public directors is not so much concerned with qualification for service as it is with remedy for corporate deficiencies and abuses.

Such a director would be a special interest representative, with divided loyalties. Beyond that, no virtue is to be found in bureaucracy, politics, office seeking, patronage, sinecures, regulation under the guise of representation. The political scene furnishes ample connotation of these terms and demonstrate that political intervention is neither a source of qualification nor of remedy.

§ 59. The Balanced Board.

Beyond individual qualifications, heed must be given to the complexion of the board as a whole.

A board must have balance and a well balanced board will be found to have some likeness to a well proportioned political slate. Reputable and well known names are desirable, since they breed confidence in investors and public consumers. Stockholder representatives are

needed for a variety of reasons given elsewhere. A lawyer—usually not more than one—is an asset. A banker, an accountant, an engineer, even a politician or a professor, one or more, may be desirable. And business men—these are essential—men who understand the techniques and pitfalls of production, factory management, sales, advertising, personnel. A combination of these skills should go into the mixture. There should be young blood and matured experience in fair proportions.

In particular corporations, expediencies need be served. Utilities and local banks need local residents, hotels are benefited by having directors with civic and trade association affiliations. Political contacts make some directors more useful. Of course, individually, these are secondary qualifications but they do make for a more useful board.

Primarily, the goal is to produce a harmonious deliberative working team wherein the whole will be greater than the sum of its parts because of the added strength of successful cooperative effort. As one quick mind stimulates another, so a balanced board can weld unit talents to greater accomplishment.

The board must have a continued life and vigor beyond those of its individual members. Its vitality, with its concurrence of courage and optimism, must be preserved.

The long service and accumulated experience of its members are of undenied fruitfulness, but the board must not thereby be permitted to degenerate into a state of decay. Infusions of new blood, with its accompaniments of youthful vigor and fresh points of view, must be sought periodically.

However, constant and frequent change should be avoided. Continuity of service yields experience that makes for expeditious and efficient functioning. And that is the desired goal.

CHAPTER IV.

Election of Directors—General

§ 60. Generally.

Generally, election of directors following management selection is like election in the deep South following a Democratic primary. Where change is possible, only an aroused electorate can make it.

Management selection of directors is made effective by the perfunctory way in which stockholders exercise their right of franchise. This stems from two principal causes: (1) the apathy of stockholders, and (2) the efficacy of the proxy machinery controlled by management. To the latter, stockholder disinterest and reaction are contributing causes; another is the stockholders' knowledge that opposition is futile.

§ 61. Proxies.

Since few stockholders attend the annual meeting at which directors are elected, with the notice of meeting the management invariably sends a proxy whereby the stockholder designates management representatives to vote his stock at the meeting.

The content of proxies and their solicitation and use, in certain respects, are regulated, in the case of corporations listed on national stock exchanges, by Securities and Exchange Commission rules. Generally the SEC role is no more than to see that management makes true and adequate disclosure. Otherwise, management is left free to determine the content of its proxy statements.

A proxy statement should adequately inform the stockholders for whom and for what their proxy will be voted. It should disclose the identity, occupations and stockholdings of director nominees. Many corporations, not subject to contrary regulation, solicit proxies without any or adequate disclosure of the names and qualifications of the directors for whom the proxies are to be voted. Sometimes this is deliberate; more often it is the product of long continued habit, as are many similar corporate faults. An unusual and curious omission was found in the proxy material of the Portland Gas and Coke Company, which, disclosing the identities of the director nominees, failed to disclose their stockholdings.

It is the function of the directors to approve proxy material and they should see that it makes adequate and correct disclosure.

§ 62. Stockholder Apathy and Reaction.

In connection with our earlier discussion respecting the selection of directors we noted the apathy of stockholders. When one considers the matter of election of directors, stockholders' laxity becomes even more noticeable. The manifestation is cogent when a proxy contest occurs; a considerable percentage of stockholders will sign nothing and an equally large percentage will sign anything. It is of common occurrence to find stockholders signing contesting proxies simultaneously, voiding both. When no contest impends, management constantly finds it necessary to employ professional proxy solicitors or use their employees to get stockholders to sign proxies so that a quorum can be obtained for corporate action which is manifestly in the stockholders' interests.

§ 63. —— Causes.

§ 63a. Small Stockholders.

That much of this stockholder apathy is due to the presence of so many small stockholders would seem a reasonable conclusion. Statistics support the premise.

A recent study of share ownership made by the Brookings Institute and circulated by the New York Stock Exchange indicates that over two-thirds of all stockholders are in the 1 to 99 share class. This substantiates individual company statistics: A 1953 release by the Eastman Kodak Company showed that as of October 1953, of its 83,996 stockholders, no individual stockholder held as much as 1% of the total shares outstanding; that two-thirds held less than 100 shares.

A questionnaire sent by United States Steel Corporation to its 280,000 individual stockholders and the answers of half of them revealed that, based on 1952 income, the income of 56% was under $5,000 per annum, that the income of more stockholders—17%—was between the $2,000 and $3,000 range than in any other $1,000 range, that eight per cent had incomes so small they paid no income tax.

The effort in recent years has been to increase the number of small shareholders. Bank-financed purchases, a New York Stock Exchange monthly budget plan, solicitation by utility companies and dealers to local consumers, employee stock ownership plans, have been some of the methods employed.

§ 63a1. Understandable.

The lack of activity of the small stockholder is natural and understandable. His small holding is not only a measure of his interest but evidence of his disinterest. His purpose in acquiring his stock is satisfied when he cashes his dividend checks and, from time to time, looks at the stock market quotations in his daily newspaper.

He has no feeling of proprietorship in the corporation. He feels no greater resentment when he hears of corporate delinquency than he does when he hears of political corruption. Though in the latter case, he may be moved to vote to replace the party in power, in the former he has what he believes to be a better choice to avoid controversy and concern, by moving into another investment. He does not buy stock to add to his burdens or worries.

While he may feel a sense of obligation that requires

him to vote to purge the political scene, he had no such feeling respecting the corporate scheme. He knows little about it. He feels no obligation to keep it democratic or to help it work by any contribution on his part.

§ 63b. Larger Stockholders.

These are of two main classes, the individual investor and the professional—the professional investor-management interests, i. e., pension funds, investment companies, insurance companies, trust and mutual funds, and the like.

§ 63b1. Individuals.

If the principal reason for stockholder inactivity is the make-up of the average small stockholder, why then may we not expect the larger stockholders to take an active interest in the affairs of their corporations. The answer is, they do—at least to the extent of keeping themselves informed respecting their investment. They attend annual meetings and read annual and quarterly reports. Holders of larger blocks of stock frequently make themselves known to management and periodically make personal inquiry to supplement the information gained from the corporate releases. Many also avail themselves of the services and advice of trained statistical and advisory departments of banks, brokerage houses and investment counsel. Many of these latter make frequent contact with management and ofttimes inspect company plants and operational facilities.

To that extent, at least, larger stockholders are active stockholders. But when adverse conditions occur,

or controversy arises, most investors prefer to move into something else that carries with it less controversy and difficulty. It is only when such an investor cannot sell his stock without a considerable loss, due either to market conditions or the size of the block, that he tends to stay with the situation and give it his attention. But even such investors, in such predicaments, are loath to take adverse action against management, and here, difficulties and expense are barriers.

§ 63b2. Management Interests.

A recent study of share ownership in the United States issued by the Brookings Institute estimates that fiduciaries, including trustees and guardians, have 11.4% of the total shareholdings, institutions and foundations have an estimated total of something less than 1% and miscellaneous holders, including insurance companies, investment companies and business corporations, have an estimated 2%, a total of 14 to 15%. This figure does not include shareholdings registered in the names of brokers and dealers, though as the report says, "it is common knowledge that large quantities of shares are registered in the names of brokers and dealers" and an estimate based on twenty selected stocks concludes that these sources hold 10.3% of the total. A report of the National Association of Investment Companies discloses total net assets of 142 members, the major portion security investments, exceeding 5 billion dollars.

Studies prepared for the Senate Banking and Currency (the Fulbright) Committee showed that, as of the end of 1954, insurance and investment companies, banks, pension funds, personal trusts and foun-

dations held 23% of the outstanding common and 54% of the outstanding preferred stocks. It found that net purchases of stocks by institutional investors had increased from 100 million in 1940 to between 2 and 2½ billion in 1954; it estimated that institutional investors, at the end of 1954, owned 66 billion dollars of stocks against 32 billion in 1949 and that of the total, 48 billion were stocks listed on the New York Stock Exchange.

According to Harold Clayton, economist, colleges, foundations, insurance companies and investments trusts own 14% or more of the outstanding common stocks of 33 of the largest American corporations.

This type of investor, of course, is an informed and active one. Many have professional investment advisers; many are staffed with competent employee investment advisers. They keep in close contact with management; managements consult with them and they are often of considerable service to the corporations whose stock they own.

The proximity and identity of interest between these investors and the corporations in which they own securities is such that investors of this class may properly be termed "management interests." Their roots and those of corporate management lie in the same soil; they are of the same caste; their social and economic interests interlock and coincide.

While, as noted, these investor interests keep in close touch with management, they deliberately—as a matter of policy—refrain from overt interference. Some will not permit their personnel to accept directorships or exercise any influence in the choice of directorships. In a proxy contest, most will throw their votes and

often their influence behind management; with rare exception, none will enter the lists against management. Efforts of various interests prepared to contest Sewell Avery's control of Montgomery Ward over the years immediately preceding the Wolfson contest met with no offer of cooperation from investment companies holding Montgomery Ward stock, although it was notorious that they were dissatisfied with the Avery management.

The reasons that dictate such policy are weighty. Once this type of investor begins to exert overt influence on corporate management, the problem arises of where the ultimate concentrated control of the corporate economy lies. Grave problems of this nature lie ahead; they are already discernible through the growing ownership power and influence of this type of institutional investor. Their resolution will have impact not only upon our economic but perhaps upon our political system.

The May 1955 report of the Senate Banking Committee found a fundamental long range issue arising from institutional stockholdings resulting in the possibility of "financial institutions having a dominant influence over the managerial policies of industrial enterprise" and reported a need for further study of the problem.

The multiplicity of these situations will pose a variety of problems, for example, those arising out of the ownership of voting stocks by union labor funds. Or one might consider the ownership by the Sears Roebuck savings plan fund of 26% of the Sears Roebuck voting stock and concurrently ruminate upon the fact that the trustees of the savings fund with at least work-

ing control of the outstanding Sears' stock are appointed by the Sears' directors who are elected by the stock vote cast by the trustees.

Presently, institutional investors seek to avoid the growing impact of their influence and control by a hands-off program—violated on occasion. Meanwhile, however, their support goes to management, enhancing the difficulty of stockholder opposition, and this conclusion finds evidence in the Wolfson-Montgomery Ward contest, although here the stockholders, in the opinion of many, were offered only a choice of evils.

§ 63c. Futility of Opposition.

Some of apathy of stockholders is doubtless due to the stockholders' belief that it is futile to oppose entrenched management. And, of course, there is substance for this belief since management controls the proxy machinery, it has the stockholder lists and the prestige of management invariably results in a considerable number of stockholders automatically returning management proxies. In addition, management has available the corporate funds with which to conduct its campaign and can enlist in its aid the services of its employees and of other management interests, to which reference is made elsewhere.

While recent events indicate that proxy fights can be won, even in the case of the larger corporations, it is undeniable that the odds favor management—statistics cited elsewhere so demonstrate—and it takes a herculean effort by interests willing to risk large sums of money, to accomplish a successful result. Certainly, except in the most extreme cases, for the average stockholder, the effort and expense required are prohibitive.

§ 63c1. Smaller Corporations.

In the smaller corporations, where the expense of a proxy contest is not overwhelming, redress may be had by aggrieved stockholders willing to make the effort. (We give some examples in a later chapter.) Here, the support of management interests is not too important a factor. However, in these corporations, it is usual to find the dominant management group owning a sufficient amount of stock to constitute working control—in rare instances controlling through a voting trust—and justifiable grievance is rare, since management has stock incentive and responsibility.

§ 63c2. Controlled Corporations.

The situation is much the same where one corporation is controlled by another, at least to the extent that the potential of remedy is nonexistent.

It has long been the custom for American corporations to operate branches of their businesses through corporate subsidiaries. Frequently, such a subsidiary corporation is not 100% owned; there are outstanding public minority stockholders.

While in these situations, the stock interests of the controlling corporation and the minority are identical, the possibilities of a diversity of interest is greater. However, except in cases of gross abuse, the stockholder's only remedy is to dispose of his stock.

§ 63c3. Larger Corporations.

§ 63c3.1. Concentrated Ownership.

Even in some of our larger corporations, minority stockholders are assured of ownership control, with its

resultant benefits and disabilities. Well-known examples are the duPont interests in duPont de Nemours Company and General Motors, Mellon interests in Gulf Oil, Rockefeller-Standard Oil, and the Pews-Sun Oil. Many smaller, but still large, companies have managements overseen or controlled by large stock groups. Though in such cases, the public stockholders are helpless to disturb management, their economic welfare is invariably in competent hands.

§ 63c4. Entrenched Management.

It is in the larger public corporations that we find situations that define "entrenched management," i. e., management owning comparatively little stock but controlling by virtue of the difficulties that attend any effort to replace it. These include corporations with good and successful management and consequent satisfied stockholders—entrenched in power by competency. However, many corporations are found where these conditions do not exist, yet the task of a challenge to management is beyond the purse of any average group of stockholders, and an attempt to overcome the natural lethargy of numerous stockholders is too herculean for any reasonable man to initiate. Here, we find challenge only when some Colossus seeks to wrest control of the enterprise from those in power.

Study and analysis leads to the justified conclusion that in many large, unassailable corporations the preponderant ownership lies in the hands of a large, scattered number of comparatively small shareholders, while relatively small groups of large shareholders own substantial fractions of the outstanding stock and the directors and officers own only small fractions of the

outstanding shares, and generally are not representative of the stock ownership.

For example, though the New York Central Railroad management, in its proxy statement filed on the eve of its proxy fight, showed ownership of 106,000 shares of a total of 6,447,410 shares outstanding, even that comparatively small holding had been recently augmented by the acquisition of 34,000 shares by directors, one, who had only had 100 shares, buying an additional 1000; and in the ensuing proxy contest, the Central Management charged that Young had controlled the Chesapeake and Ohio Railroad with only 1.3 per cent of its stock.

The expense of circularizing, with private means, a large number of stockholders, while management enjoys the use of the corporate funds, is an obvious barrier. The larger life insurance companies, one of which has 28 million policyholders entitled to vote for directors, make such an undertaking ironic.

Beyond the bar of cost, the difficulty of unifying the opinion of small scattered stockholders is an imposing task. The recent Brookings study documents two of the factors to which we have adverted; the small fractional holdings of management and the small fractional holdings of the scattered public stockholders. As to the former, the limited study reports that the average percentage of employed persons who own stock in the companies by which they are employed is 3.2%. While this may not include directors, it necessarily includes operating management, i. e., officers, and also minor and subordinate employees. So it is fair to conclude that in these larger corporations whose stock is traded, the percentage of management stock ownership is

small. Similarly, of the entire body of shareholders, over two-thirds are in the 1 to 99 share group, 31% have less than 1,000 shares and only 2.1% have more than 1,000 shares. And these corporations have issued, in the aggregate, 3,695,279,000 shares.

Merely enumerating the number of shareholders in the larger corporations demonstrates the futility of attempting a contest with management. Of thirty large corporations, the smallest has over 50,000 stockholders; the largest over a million. Approximately half have over 100,000.

§ 63c5. Supporting Interests.

Ordinarily, in any effort to replace management, the latter can look to the support and the influence of other financial and industrial management interests.

Illustration is furnished in the New York Central Railroad contest, when leading insurance companies announced their support of the management group and the contestant, Young, charged that four large banks were participating in the effort to secure management proxies and added that the banks derived substantial benefits from business given them by the railroad. Pointing out the small stockholdings of four leading bankers on the board, he charged that "the directors and officers of these four banks interlock with 50 other industrial companies and 14 other railroads having assets of more than $107 billion." In fairness, it might be pointed out that in a printed letter the president of J. P. Morgan and Company, one of the four banks, said that the bank welcomed "the opportunity to demonstrate once again that the theory of Morgan banker domination is a fantasy and a myth."

Young himself was not devoid of similar support—he had built his challenge about 800,000 shares acquired by two friends who were controllers of a large number of large business enterprises and the support of Alleghany Corporation, a large investment enterprise which he and his close associate, Kirby, controlled.

Illustrating how even labor has become "Big Business" and exerts its influence as such, we find in the struggle for control of the Fruehauf Trailer Company, the International Brotherhood of Teamsters buying a million dollars of the Fruehauf stock, allegedly in order to aid the management in the pending contest, while in the Wolfson-Montgomery Ward contest it appeared that the same union owned 26,000 shares of Ward stock.

As previously noted, even in the Montgomery Ward proxy contest, where little excuse could be found for the continued Avery rule, "management interests" rallied behind the incumbent management, although it must be admitted that they could justify doing so since the nature of the opposition was not such as to appeal to conservative elements of our economic society.

§ 63d. Stockholder Activity.

As apathetic stockholders tend to create lethargic directors and officers, so active stockholders stimulate them to effort. Enlightened management welcomes reasonable and intelligent stockholder activity and often offers such stockholders places on the board. Even with reactionary management, a strong stock showing will gain board membership, even when not strong enough for a contest. Only the most arbitrary

management will invite a proxy contest, or not seek to avoid one.

§ 63d1. Examples.

Following a letter sent to shareholders by a committee, the management of the Blair Holding Corporation announced that the chairman had resigned and that the management proposed to reorganize the board by dropping six members and replacing them with three new directors.

A threat to seek a special meeting to elect "more independent nonmanagement directors" of Allen B. Du-Mont Laboratories was apparently ended when the president's brother resigned and a partner in a New York investment banking house representing 350,000 shares was elected to the board.

§ 63e. Board Representation.

The most effective way of dealing with stockholder dissatisfaction is by according places on the board to active and competent stockholders. It is rare that compromise and cooperation does not follow. Where the stockholders' dissatisfaction is unwarranted, the truth promptly prevails. Where management is at fault, even a single stockholder-director, who handles himself competently, can secure cooperation to remedy the fault.

§ 63e1. Examples.

§ 63e1.1. Unfounded Dissatisfaction.

After years of litigation in the courts, a compromise was reached and a board set up on which the objectors

received a majority of the places. To permit this, several members of the old board voluntarily resigned. Now, for the first time, the objectors had an opportunity to view operations from the inside. As a result, at a management dinner held at the end of the first year of service of the reorganized board, the leader of the opposing group, now a board member, announced that now that he had had an opportunity to become familiar with the character of the management group he had opposed and its methods of operation, he was prepared to disclaim the charges previously made. He added that he saw no need for a factional majority and was prepared to propose an increase of the board to include those who had resigned to permit the compromise board.

§ 63e1.2. Compromise and Cooperation.

An old line company, after one proxy fight, gave a strong stock group minority representation, in order to avoid a second contest. The minority had advocated policies which the management branded radical and impracticable. After a period, the management consented to the organization of an executive committee, on which the minority percentage of vote and influence was increased. After several years of working together, all factional differences were found resolved, the controversial policies merged into a common course of action, stockholder dissatisfaction was no longer in evidence, and the board chairman bragged that the board had not divided on a single vote in more than a year.

§ 63e2. Effect of Cumulative Voting.

The presence of cumulative voting spurs the efforts

of active stockholders to obtain board representation and thereby substitutes conciliation for dissatisfaction and controversy. We discuss the advantages and disadvantages of cumulative voting later.

CHAPTER V

Election of Directors—Proxy Contests

§ 64. Proxies.

Since few stockholders attend meetings in person, directors are elected and other corporate business is transacted at a stockholders' meeting through the medium of stockholder voting by proxies which the management and other interested persons send to stockholders in advance of the meeting with the request that they be signed and returned.

The standard form of proxy submitted to the stockholder for signature designates one or more agents or proxies to vote the stockholder's shares in the event of the stockholder's absence at a stated meeting or any adjournments thereof, for specified purposes and for such other business as may properly come before the meeting. The standard form of proxy also revokes any proxies theretofore given by the same shareholder for

the same meeting. A proxy need not affect all the shares owned by the stockholder; if he so specifies, he may give more than one proxy, each for portions of his entire holding.

Some states have laws limiting the time during which a proxy previously executed may be used.

§ 65. —— Solicitation of Proxies.

The solicitation of proxies respecting securities listed on a national exchange and of securities of registered utility holding and investment companies is subject to the rules of the Securities and Exchange Commission. These rules are generally designed to effect disclosure of necessary facts to the shareholder and to prevent the circulation of false or misleading statements. (Incidentally, they lay down what should be fair and standard practice for all proxy solicitations, whether of listed or over-the-counter securities and it is to be noted that the May 1955 report of the Senate Banking Committee investigating the stock market found need for broadening the SEC jurisdiction to over-the-counter companies and a subcommittee engaged in an investigation of the efficacy of the present proxy regulation.)

It might be noted that though the SEC proxy rules represent an effort to level the advantage of management over the dissident stockholder, they seriously hamper and delay the small and obscure stockholder while they constitute little bar to the large and important interest. The small stockholder must await the mandate of the Securities and Exchange Commission before he can say anything to his fellow stockholders, he must suffer the delay of clearing his material with

Washington (though his headquarters may be geographically remote). The large and important stockholder, through his publicity agent, can disseminate his uncensored information and argument through the medium of press conferences, news stories and advertisements, of which media the New York Central, New Haven and Montgomery Ward contests furnished prime example.

The Securities and Exchange Commission rules require that a copy of the current annual report be sent to the stockholder solicited either concurrently with or preceding the transmission of the proxy material. The initial proxy material must be filed with the Securities and Exchange Commission at least ten days before its use; follow-ups and other subsequent material, at least three days. During this time the Commission staff indicates approval or disapproval of the material submitted; in the latter event, suggests the necessary modifications.

Since stocks owned on margin are carried in brokers' names and many stocks are permitted to remain in brokers' names—so called "street names"—for a diversity of reasons, though they are beneficially owned by others, the rules of the New York Stock Exchange require members to transmit proxy soliciting material to customers owning stock in the broker's name. This is sent at the expense of the solicitor with a notice that the broker will vote the stock if no dissent is received from the customer in ten days. However, if the broker knows of any controversy respecting the vote, he may not vote the stock without specific instructions from the owner.

When management seeks proxies for election of di-

rectors of a corporation subject to the proxy rules, it must file its proxy material with the Securities and Exchange Commission and this must disclose, among other things, the beneficial stock ownership of each nominee, his principal occupation and his business experience over the past five years.

A person who is not connected with management may solicit not more than ten persons for proxies; if he seeks to solicit more than ten, he must file his written proxy material with the Securities and Exchange Commission and have it cleared.

A stockholder who desires to solicit proxies but who lacks a stockholders' list may require the company to send his proxy material to shareholders, at his own expense. The company may, at its option, furnish the stockholder with a shareholders' list so he can mail his own material.

§ 66. —— Stockholders' List.

Since it is disadvantageous to attempt to communicate with stockholders indirectly through the medium of company facilities, the law in most states, with some qualifications to insure good faith, requires that a company make its stockholders' list available to bona fide stockholders, on demand. Usually such a request meets with ready compliance, since most states impose a penalty for noncompliance. However, on occasions, a management will require stockholders to take recourse to the courts in order to obtain such a list.

In addition to the general requirements for a stockholders' list, most states also require that a company open and keep open its stockholders' list for inspection by shareholders or their representatives, for a definite

period, frequently ten days, preceding the date of the annual meeting.

A stockholder entitled to inspect a list, or his agent, may copy the list for his own proper use; ordinarily, a company will cause its transfer agent to run off a list at the stockholder's expense.

It should be noted that as a matter of general corporate law, a director is given even greater rights than a stockholder to inspect corporate books and records, including stockholder lists.

Two examples of company attitudes respecting inspection of stockholder lists may be given:

In the case of Puget Sound Power and Light Company, a State of Washington utility incorporated in Massachusetts, the company refused the request of seventy-five stockholders holding one hundred and fifty thousand shares of an outstanding issue of two million shares, to inspect the stock list. The ensuing litigation delayed the stockholders' inspection for two years.

By way of contrast, stockholders of Missouri Public Service Company, when denied a list, were able to secure a court hearing within a week following their original demand.

§ 67. —— 100-Word Statement.

Under SEC rules, a stockholder entitled to vote at a meeting may require the company to include in its own proxy material a proposal submitted by him, and this may include a statement not exceeding one hundred words giving the reasons advanced by him in support of the proposal. The proposal must be "a proper subject for action by the security holders" and this defini-

tion has awakened some controversy, the SEC holding that the proposal may include not only matters upon which stockholders are legally authorized to act but also matters upon which stockholders may properly advise directors. In a suit brought by labor stockholders of the American Telephone and Telegraph Company, the court refused to sanction the inclusion of a labor proposal in the proxy material, holding that it was not a proper one since it concerned only ordinary business operations.

§ 68. —— Advertising.

Absent a stockholders' list, dissident stockholders sometimes resort to newspaper advertising. For example, an advertisement in the Wall Street Journal: "Thompson-Starrett Co. Inc. Stockholders—Attention—Proposed merger discussion 3:00 P. M. Today . . . at the New Yorker Hotel—Please attend to protect your investment."

The handicap of such an appeal is overcome on occasion, for example when management requires a two-thirds vote for approval of a merger plan, as in the situation just mentioned. For another example, stockholders of American Car and Foundry Company rejected a company proposed recapitalization plan requiring a two-thirds vote, when a preferred shareholder opposing it communicated with other preferred shareholders through the advertisement medium.

§ 69. Proxy Contests.

From time to time, serious differences arise between stockholder groups and incumbent management. When these become irreconcilable, a proxy contest may result.

The difference usually involves matters of policy but a policy difference, as in a political contest, results in a clash of personalities and ultimately is manifested by a contest for places on the board. However, that the contest may revolve about policy only is illustrated by the following 1954 situations.

§ 70. —— Bases—Policy.

An investment company, holding a considerable percentage of the stock of American Hawaiian Steamship Company, pointing out that the shipping business was no longer profitable, called on management to permit stockholders to take available company cash for their stock and withdraw. The management defeated the proposal. Later, a director advanced proposals to change company operational policies and bylaw provisions and these were defeated at the 1955 annual meeting.

Stockholders of the Naumkeag Steam Cotton Company were defeated in an effort to obtain an outside management survey, following an unsuccessful attempt to defeat the management slate of directors.

Stockholders of the Prosperity Company, maker of commercial laundry and dry cleaning equipment, at the instance of the management twice rejected a proposal to sell the assets of the company to another company of the same name; the proposal evidencing an effort of a disfranchised class of stock to gain full voting rights.

Stockholders of Holiday Brands, Incorporated, manufacturer of a coffee product, defeated a management proposal to turn control of operations over to a professional management company.

A Telautograph-Reo stockholders' group defeated management and gained control of Reo Holding Company on an issue of whether the company should be liquidated.

American Investment Company of Illinois management defeated a proposal for cumulative voting.

§ 71. —— **Management Shortcomings.**

When dividends are lacking or insufficient, stockholders may be inclined to seek a change of management. However, proxy contests resulting from stockholder dissatisfaction are comparatively rare because of the difficulty and expense of the effort, as previously noted. Nevertheless, where there is genuine stockholder dissatisfaction, concerted effort will produce result, either a majority of the board, as in the case of R. Hoe & Co. and the Minneapolis and St. Louis Railway during 1954-5, or board representation for the minority as in the cases of Gruen Watch Company, Peabody Coal Company, Aluminum Castings Corporation, Timm Aircraft Company, Pacific Associates, among others.

However, where the corporation is a large one, a successful contest calls for something more than stockholder grievance and normal effort. It calls for a desire for control that goes beyond desire to redress stockholder dissatisfaction. On occasion, this effort to get control stems from outside sources which either acquire stock for the purpose of initiating a proxy contest or to stimulate existing stockholders to do so. So, for example, after the head of a food company had unsuccessfully attempted to foster a merger between his company and Libby, McNeill and Libby, it was rumored that

an attempt to gain control of the company would be made by a stockholders' group headed by a large stockholder through whom the previous merger effort had been made.

A January 1955 survey by the American Institute of Management listed twenty-seven proxy contests for board control in 1954 and twenty-two in 1953. Of these, nineteen of the 1953 companies had assets in excess of ten million dollars, as did seventeen of the 1954 companies. Management was successful in nine of the ten in 1953—one divided equally; of the seventeen in 1954, the opposition succeeded in five and divided equally in one. Of the five in which the opposition succeeded, three were railroads, the New York Central, the New York, New Haven and Hartford and Minneapolis & St. Louis. Of the companies with less than ten million dollars of assets, the opposition succeeded in twenty-five percent of the contests in 1953 but in only one of eleven in 1954.

§ 72. —— Interests Seeking Control.

When, by reason of poor management or industry conditions, a company's stock is found selling for less than its book or liquidation values, and particularly when earnings are poor because of a large cash or liquid asset position yielding little return, the depressed market price offers invitation to outsiders to seek control, either for purposes of rehabilitation or liquidation. A number of stock specialists have developed this practice and it has proven profitable. In street parlance, these are commonly known as "special situations."

The post-war period has witnessed radical industry changes, many due to technological changes and advances, to increased competition due to the expansion

of wartime production facilities and the subsequent lessening of production peaks. Wartime profits have produced accumulations of liquid capital funds and have geared aging family ownerships to retirement. The consequence has been a demand by established companies for investment in other allied and diverse enterprises for tax, diversification or expansion purposes. Successful companies have been seeking opportunities for investment of their surplus funds; unsuccessful companies have been seeking control of successful companies so as to employ their tax loss bases.

The concurrence of these conditions has resulted in mergers and acquisition of control of companies, either through purchase of stock sufficient for working control, in which event a change of management when made is made without controversy, or through the acquisition of sufficient stock to stimulate and justify a proxy contest.

For example, when Container Corporation acquired 63% of Mengel Company stock, it elected six of seven directors at the next annual meeting; but when Pennsylvania Coal and Coke found it could not get control of Industrial Brownhoist by stock acquisition alone, it engaged in a proxy contest for the purpose. In the case of the Marion Power Shovel Company, a stockholder solicited proxies and as a result, caused to be elected three directors—one the general manager of Merritt Chapman and Scott Corporation, an international heavy construction and marine salvage company—to a board of nine. The president of Marion said that he had had no advance warning of the intention of Merritt Chapman to seek representation on the Marion board; he added that he did not believe management

operating policies were in question. Later Merritt Chapman gained full control.

In another situation, the same Pennsylvania Coal and Coke (the name now Penn-Texas Company) sought by open market purchases to get control of Niles Bement Pond. The latter management retaliated by seeking to issue treasury or unissued stock to Equity Corporation in exchange for stock of Bell Aircraft Company. A group of Niles' stockholders intervened and enjoined the exchange of stock whereupon the proposal was dropped and Penn-Texas gained control.

Reliance Manufacturing Company and Safie Brothers Company engaged in a struggle for control of Rice-Stix, Incorporated; the former gained a majority of the board.

Security Bank Note Company defeated a merger proposal of Lanston Monotype Machine Company and Cuno Engineering Company and won control of Lanston.

Consolidated Textile Company purchased 44% of the stock and acquired control of Bates Manufacturing Company. Meanwhile the incumbent management sought legislation to amend the state corporation law to require an unprecedented 80% stockholder vote for a merger, in order to block any such effort.

§ 72a. Depressed Industries.

In the textile industry, with the market discounting book and liquidation values, within a short period, Burlington Mills acquired working control of Pacific Mills and Goodall Sanford Company by public offers to buy stock above the market, Textron engaged in a proxy contest after buying enough stock for working control

of American Woolen, and J. P. Stevens bought control of J. P. Maguire Company from the management.

In the anthracite coal industry, new control groups took over Lehigh Valley Coal Company, after a proxy fight, and the management of Glen Alden and Lehigh Valley Coal and Navigation Company passed into new hands. Thus management of three of the five large producers constituting the industry were affected during a period of depression.

Proxy contests resulted in change of management of the New York Central, the New York, New Haven and Hartford, and the Boston and Maine Railroads.

§ 72b. Business Reasons.

The desire to expand, to reduce competition, to more fully integrate an established business, to diversify a business affected adversely, to seek profits to offset against tax loss carryforwards, each is attested by daily newspaper reports. So, for example, we find Textron seeking to buttress its operations in the over-competitive textile industry by acquiring a concern that manufactures vibration devices, one that makes radar antennae, another that manufactures upholstery filling; and thereafter merging with American Woolen and Robbins Mills. We find the New York Shipbuilding Company acquiring control of a construction firm, a housewear manufacturer, a paint manufacturer. The Pressed Steel Car Company announces that its freight car business, once its sole operation, is now reinforced by control of concerns manufacturing oil well pumping equipment and dairy cans. Similarly, Pennsylvania Coal and Coke Company, engaged in the coal business, acquired oil wells and machinery concerns. And after

a successful contest to gain control of Lehigh Valley Coal Company, the new management announced its intention of seeking to acquire companies in other fields. Glen Alden Coal Company made a similar announcement in its 1954 annual report and thereafter changed its corporate name and acquired an air-conditioning concern.

The trend is illustrated by advertisements in the Wall Street Journal: (1) "We want to buy profitable operating Company—Essential That Your Management Stay on Under Contract to Continue Operations—Our company listed on New York Stock Exchange now doing volume approximately $30,000,000 per year is embarking on diversification and expansion program." (2) "Will purchase stock control, listed or unlisted company—involving seven figures. All cash. Will make very attractive offer to your stockholders and management. No red tape, best banking and social background."

The trend has resulted in specialists seeking out companies subject to acquisition, with or without management acquiescence; one such broker claimed to have a list of three hundred such prospects.

The desire to expand or to limit industry competition results in acquisitions within an industry, such as those previously referred to in the textile industry. These take the form of stock acquisitions or mergers and rarely necessitate proxy contests. Examples are furnished by many of the acquisitions previously noted.

The acquisition of large blocks of a company's stock by investment companies finds illustration in the monthly SEC reports to those companies. While they are numerous, they are of academic interest here since

their purpose is investment and interference with management control is rare.

A somewhat exceptional instance of control on the block was found in the case of the International Hydro-Electric System emerging from SEC reorganization. Here speculative interests had purchased the old control stock during the period of reorganization; when final consummation was at hand, an outside group, desirous of getting the benefit of the tax loss advantages of the company, sought to acquire sufficient stock for working control. The result was a contest between the two groups and cumulative voting resulted in a four to three but still contested victory for the late-comers.

In the Detroit and Cleveland Navigation Company proxy fight, it appeared that its president decided to get control of the Fruehauf Trailer Company and had a friendly labor union invest a million dollars in the Fruehauf stock. The president of the latter company retaliated by going into the D. and C. situation and ultimately won both fights and then undertook to liquidate the D. and C.

§ 73. —— Director's Attitude.

The attempt of either existing stockholders or of outside interests to acquire management control is not necessarily a matter of official concern to a director, except as he may believe a change of control may be helpful or detrimental to the company or its stockholders. Certainly, to the extent stockholders legitimately seek to replace incompetent or dishonest management, such an effort should meet with no less than approval by directors committed to the interests of the stockholders. How much further a director who is a

member of incumbent management should go poses difficult questions which can best be met by a resignation of the director who wishes to join with the opposition, unless the director has not looked to incumbent management for his post. Nevertheless, it is a rather difficult situation for a director in office to actively aid the opposition while continuing to serve with management, in the absence of an open rift. The questions which may arise in such a contingency are, however, largely matters of manners, convenience and taste rather than of a legal nature, although, for example, a director who seeks to exercise his normal right of inspection of corporate books and records for the ulterior purposes of an opposition may find his right challenged legally.

Where the effort is one by an outside interest to gain control, an incumbent director should not seek to serve the conflicting interests. Certainly he should not use the privileges of his directorship, his right to inspect records or the stock list, or the confidential information he receives, to aid the opposition.

Where the outside interest is such that its control threatens to endanger the stockholders' interests, a director is obligated to lend his efforts to repulse the invader. Nor should a director aid undisclosed interests who seek to purchase control or acquire sufficient stock to enable them to engage in a proxy fight.

In the rush of efforts of outside interests to gain control of companies during the post-war period, examples of blind offers to buy stock have not been infrequent. Instances of control being sold without regard to the identity, character or ability of the purchasers, or without regard to their motives have not been

unknown. (A subcommittee of the Senate Banking Committee in 1955 started an investigation of such practices.) The director, while in office, is pledged to faithfully represent the main body of stockholders and though numerical or voting control is vested in a single group, his obligation extends equally to seek to protect the minority.

Obviously, no rule can be laid down to cover each situation. Only adherence to the basic principles of trusteeship can determine a director's individual course in each case and he must seek to lay out that course in disregard of his individual interests, a necessary requirement of the trustee rule.

§ 74. —— Advantages.

While proxy contests are to be avoided, their advantages are not to be deprecated. Where a contest represents a genuine stockholder effort spurred by just grievance, its successful conclusion not only should end existing abuse but should exercise a therapeutic effect on other managements disposed to deny stockholders' effort to gain minority representation.

Even an unsuccessful contest awakens management to the need for creating better stockholder relations.

When the contest is the result of an effort by an outside interest to gain control, its consequences should be beneficial to public minority stockholders. If successful, the new interests will seek to make their stock more fruitful, unless the motive in seeking control is ulterior, which is of rare occurrence. If unsuccessful, it will make management dependent upon public stockholder support and it will act accordingly.

A proxy contest is bound to generate promises of

correction from both sides. The criticism which it engenders awakens management to its faults.

For example, during the Young-White contest, the management published stockholder appeals headed "Destination-Dividends! William White outlines a realistic program of potential savings and earnings for New York Central," which had gone without paying dividends for some time.

With a threat of stockholder opposition, the Puget Sound Power and Light management increased its dividend to $1.64 on earnings of $1.85, a pay-out of 90%, and hired experts to make financial studies and publicized their findings that the stock had a "present reasonable investment value of $33 a share" and that a value of $40 to $46 per share was "reasonably in prospect within 10 years." As a consequence, the stock, which had been selling for $22 a share, moved up beyond $30 and thereafter the management showed increased earnings for 1955 and predicted even better ones for subsequent years.

When large interests seek stock for voting purposes, the market rises and offers opportunity for sceptics to sell before the contest ends and the market reflects only usual demand. In only four of twenty-seven cases of 1954 proxy contests did the stock of the company fail to show a rise in market value, according to the American Institute of Management survey.

§ 75. —— Disadvantages.

§ 75a. Expense.

We noted previously that the expense of a proxy contest is a deterrent. Obviously, when a large in-

terest buys in to obtain control, the expense of the contest itself is a small factor in the overall cost. The International Hydro purchaser contestants referred to acquired some 300,000 shares at a cost of $7½ million. The Young interests got set for the New York Central fight by buying 800,000 shares for $20,000,000. Textron made open market purchases of American Woolen stock and offered stock exchanges at an estimated cost of four to five million dollars. Wolfson interests bought large amounts of Montgomery Ward stock in preparation for their proxy fight.

The expense of a proxy fight in a large corporation is not inconsiderable. Even in a small one, it can be burdensome to the contestant who, while the management pays from the corporate treasury, runs the risk of bearing the cost of an unsuccessful contest. When the opposition wins, it causes the corporation also to assume its expense, so that from the standpoint of the stockholders, they bear at least half the expense when the contestant is unsuccessful and double that when he wins. An example of the latter was furnished in the case of the successful contest to replace the management of the Fairchild Engine and Airplane Corporation when, in addition to the original management expense of $133,000, the corporation paid the contestant's cost of $127,000.

The expense of the Young-Alleghany opposition to the New York Central management was in excess of $1,300,000 which was advanced by Alleghany, a public corporation. The management expense was paid by the New York Central. After the Young interests took over, they had the stockholders vote to have Central reimburse Alleghany.

In the course of the Wolfson-Avery contest for control of Montgomery Ward, Wolfson had initially estimated his proxy expense at $250,000; later it appeared it might exceed half a million dollars. During the contest he complained that the management was spending large company sums to defend its rule; later management's expenditure was estimated at $750,000.

Following the Fairchild contest referred to above, a stockholder challenged the right of reimbursement by the corporation for the proxy expenses and the highest New York court laid down rules for reimbursement in the following language:

"In a contest over policy, as compared to a purely personal power contest, corporate directors have the right to make reasonable and proper expenditures, subject to the scrutiny of the courts when duly challenged, from the corporate treasury for the purpose of persuading the stockholders of the correctness of their position and soliciting their support for policies which the directors believe, in all good faith, are in the best interests of the corporation.

"The stockholders, moreover, have the right to reimburse successful contestants for the reasonable and bona fide expenses incurred by them in any such policy contest, subject to like court scrutiny.

"That is not to say, however, that corporate directors can, under any circumstances, disport themselves in a proxy contest with the corporation's money to an unlimited extent.

"Where it is established that such money has been spent for personal power, individual gain or private advantage, and not in the belief that such expenditures are in the best interests of the stockholders and the

corporation, or where the fairness and reasonableness of the amounts allegedly expended are duly and successfully challenged the courts will not hesitate to disallow them."

As an example, in one situation, stockholders sought by cumulative voting to elect a minority of the directors to represent them, instead of management nominees. In the course of the ensuing proxy contest, the management admitted the stockholders' right to nominate and seek to elect its nominees.

In such a situation it would seem that the management opposition was admittedly personal since nothing of moment could be urged against the stockholders' nominees; consequently, the usual right of the management to charge the expense of opposition to the corporation would seem to be less than debatable; in such case the respective contestants should themselves have properly borne the cost of the contest.

§ 75b. Damage to Business and Good Will.

It is to be expected that when management's attention is diverted from operations by a contest for control, current operating results will suffer. Management personnel is disturbed; discouraged good men may seek other and more stable connections. The charges and recriminations that mark a proxy fight tend to become current among consumers and customers and shake confidence in the company's products and services.

The inevitable consequence of the circulation of management criticism among stockholders and brokers is to destroy stock market good will and may produce a poor market in the stock after the period of contest has ended. During a proxy contest, in which financially

powerful interests are prepared to buy stock for voting purposes, the market moves up in response to the demand; however, the situation may change once the voting date is past and a weak market may be expected, unless a strong group in whom confidence can be reposed has gained control.

Effort, through a proxy contest, to gain control by outside interests lacking public confidence, may seriously affect employee, customer and stockholder morale. "Raiders" with insufficient funds may seek to recoup and repay borrowings to secure control with company resources once they have gained control. Such contestants, when successful, may seek to benefit their other enterprises to the disadvantage of the newly-acquired concern, its business or assets. Such contestants may have other ulterior purposes and thereby damage the credit and standing of the acquired company. Even a Napoleonic complex or a predilection for excessive "leverage" may offer difficulties to a proxy-acquired company.

In short a constructive market and other favorable factors that make for stockholder and public good will are destroyed by their antitheses. From recriminations during a proxy contest the business of the company may never fully recover. Often one contest engenders recurring management-stockholder squabbles. As a result, some companies ultimately find themselves in the bankruptcy and reorganization courts.

United Cigar Stores, Thompson Starrett Company, Hudson and Manhattan Railroad, F. L. Jacobs Company, Segal Lock and Hardware Company, R. Hoe and Company are a few examples of companies that suffered from proxy contests. A 1954 news report an-

nounced selection of a new president, the fifth since June 1952, of the F. L. Jacobs Company, following assumption of control by a stockholders' committee in 1952.

Announcement of "a backstage fight for control" of Texas International Sulphur Company was accompanied by a statement that suits were pending between the stockholders in both the Mexican and Texas courts and that operations of the company "are apparently at a standstill and the company is believed to be in poor financial shape."

§ 75c. Invitation to Competitors and Outsiders.

Proxy contest exposure of management and corporate weaknesses arm competitors in their search for customers; it may stimulate them or market speculators to acquire the business itself. What has been the concealed bases from which astute stock market specialists have concluded a "special situation" exists in the stock become public property and invite the attention of the otherwise uninformed.

For example, once the management and stockholders of American Woolen Company found themselves engaged in a contest to determine whether the company should retire its preferred stock, Textron moved in to acquire control and to prevent the merger of American with Bachmann Unabridged Worsted Company. During the melee, the president of the employees' union charged that American Woolen was "being clawed over . . . by greedy speculators . . . seeking to lay hands on the company's $43,000.000 working capital."

In the case of the Monroe Paper Products Company, a management which survived one proxy fight

designed to yield control to the National Container Corporation, found itself in a struggle, less than a year later, to avoid Waterbury Container Company's effort to take over.

§ 75d. Litigation.

The litigation generated by a proxy fight may prove enervating and expensive. And it often continues after the vote has been taken.

The American Woolen contest was marked by suits for stockholders' lists and injunctions to prevent meetings and counting of votes. The New York Central contest went on before the Interstate Commerce Commission and the state courts, with public examination and cross-examination of the contestant Young and Central's president, White. The New Haven vote, which was preceded by ICC petitions and cross-petitions, was followed by suits to test the validity of the votes. The International Hydro election was followed by similar litigation.

Stockholders of New York Shipbuilding Company sued Wolfson to prevent his use of corporate funds to further his effort to gain control of Montgomery Ward.

In an effort to oust the board of J. F. Byers Company and thereby overcome the delay of the stagger system, the conflicting parties engaged in subsequent litigation to determine whether the effort required a vote of the majority present at a meeting or the majority of all outstanding stock.

As previously noted, the Niles Bement contest included litigation to enjoin a threatened exchange of unissued stock for Bell Aircraft stock and determination of the contested date for the meeting.

The Montgomery Ward contest spurred the Wolfson litigation which resulted in the Illinois decision to end staggered boards; the prospective contestants versus the Pennsylvania Railroad instituted similar litigation in the Pennsylvania courts. As a result of the publicity attendant upon the larger contests, a Senate Banking Subcommittee started an investigation and took the testimony of Wolfson, Young and others.

CHAPTER VI

Election of Directors—Method, Practice and Procedure

§ 76. Entire Board by Majority.

Conventionally, at the annual meeting each year, stockholders present in person or by proxy, by majority or plurality vote—in some cases statutes determine—elect an entire board. Thus only the majority, and, as a practical matter the management, which has secured the proxies of the acquiescent stockholders, is represented on the board. The minority has no representation. Dissatisfied stockholders must command a majority vote to gain representation, and then they elect the whole board.

For example, the contestants in the New York Central and Minneapolis and St. Louis contests had to

gain a majority and having done so, elected their entire slates; the minorities, the superseded managements, lost all representation on the board.

§ 77. —— Stagger System.

In some corporations, the charter or bylaws provide that the stockholders at each annual meeting elect only a percentage of the board, the term of each director so elected running beyond a single year. So, with a board of nine, three directors, each to serve three years, may be elected each year. The percentages and the terms of office may vary.

The purpose of employing such a method—a legitimate and justifiable one—is to assure continuity in office of a majority of the directors beyond a single election, since only a minority come up for election or re-election each year. The ulterior purpose of such a device is to discourage stockholder contests, since a majority of the board cannot be replaced in less than two years and the contesting stockholders face the necessity of conducting not one proxy contest, but at least two. However, where the antimanagement forces can command a majority vote, the stagger system offers management no protection, since ordinarily a majority of the stock can effect the necessary amendments to the charter or bylaws to abolish the stagger system.

It is doubly interesting to note a news report that the F. L. Jacobs Company, which had been suffering from stockholder dissension for some years, in consequence of which management had been removed, while under control of the successful stockholder forces proposed staggering the terms of office of its directors. The proposal might have awakened the suspicion that

the existing stockholder management, now being the "ins," was desirous of perpetuating its control against subsequent attack.

When stockholders are the "outs," they do not take kindly to the stagger system as witness the American Woolen situation where a "fact-finding group" of stockholders, set up with the concurrence of management, in an attempt to reconcile conflicting views, recommended the abolition of the existing stagger system of electing four new directors for three year terms and also the Montgomery Ward-Wolfson attack on the stagger system referred to later.

§ 78. Cumulative Voting.

As a means of assuring representation to a substantial minority of the outstanding stock, the system of cumulative voting has been devised. This is akin to the political method known as proportional representation, designed to afford representation in legislative bodies to political minorities.

§ 79. —— History and Statistical Data.

Though cumulative voting found birth in Illinois as far back as 1870 and other states followed the lead either by requiring or permitting cumulative voting, and the American Bar Associations Uniform Business Corporation Act of 1928 provided for cumulative voting, impetus to this method of electing directors was gained as a result of federal recognition of the principle under New Deal sponsorship, with the result that the 1933 Federal Banking Act and the reorganization provisions of the Bankruptcy Act, called for cumulative voting. While the Public Utility Hold-

ing Company Act of 1935 contained no such requirement and the Securities and Exchange Commission denied an application to require cumulative voting made by the writer of this text in the reorganization of the Puget Sound Power and Light Company in 1943, thereafter it consistently required such provision in reorganizing the utility companies under its jurisdiction, with the result that such method of election has become common to those companies.

According to a 1955 study made by Whitney Campbell (The Business Lawyer—April 1955), thirteen states have constitutional requirements for mandatory cumulative voting, seven have similar statutory requirements, seventeen states and the District of Columbia have permissive statutes, and eleven states have no express provision one way or the other.

A 1940 study made under SEC auspices of 1933 American corporations with securities registered on national exchanges showed 633 or 32.7% were incorporated in states with mandatory requirements, 1,182 or 61.2% were incorporated in permissive states and 118 or 6.1% in states with no provision for cumulative voting.

A report by the National Industrial Conference Board (1953) stated that of 261 companies reporting on cumulative voting, 150 companies were incorporated in permissive states and in all but approximately 10%, cumulative voting was provided for, while of the total, 24 companies were incorporated in mandatory states, and accordingly provided for cumulative voting.

According to Professor Williams of the Harvard Business School, of 189 registered corporations incorpo-

rated in states where the corporation may make a choice, only 11% have cumulative voting.

Although such major corporations as the American Telephone and Telegraph, Western Union, Standard Oil of New Jersey and General Motors have resisted minority demands for adoption of the cumulative voting system, within recent times, the management of the American Gas and Electric, the second largest electric energy distributor in the country, apparently influenced by SEC pressure, recommended a change to cumulative voting and the New York Times noted, with some show of astonishment, that Harrison Williams, long a foe of utility management reform, voted for the change, while Harvard University, a large stockholder through its endowment fund, registered opposition.

According to an article in the New York Tribune, "bankers seem to be generally agreed that the national banking system would be better off without" cumulative voting, and recent studies culminated in a bill which passed the Senate in 1955 to abolish the mandatory practice so far as national banks are concerned.

§ 80. —— Method of Voting.

The standard method of election of an entire board by majority stock vote contrasts with election by cumulative voting in that, under the standard method, each stockholder casts one vote for each share of stock held by him (in exceptional cases a share of stock may carry a greater number or lesser fraction of votes) for each director nominee, while under the cumulative system, he casts as many votes per share as there are nominees to be elected and divides them among the

nominees as he sees fit. Under the standard system, 51% of the stock present elects the entire board and the minority, though it be 49%, gets no representation; under the cumulative system, 51% of the stock can elect only a bare majority of the board, and the minority can elect a corresponding minority of the directors. Under the cumulative system, 10% of the stock can elect one director on a board of 9, 16⅔% one director on a board of 5, 25% one director on a board of 3, etc. (It will be found, as a rough but simple rule of thumb, that the required percentage will be determined by dividing 100 by the number of directors to be elected plus one.)

To determine the number of shares or votes needed to elect, one must estimate the percentage of shares or votes to be represented at a meeting. Assume 1000 shares outstanding, an estimated 80% attendance and 9 directors to be elected. This gives 800 shares present and voting and if this number is divided by the number of directors to be elected plus 1, and the quotient—80—increased by one, the number of votes needed to elect one director will be found. It will be seen that in whatever manner the remainder of the 800 shares present—719—are divided, their holders cannot elect more than 8 of the 9 directors. Similarly, if the problem is to elect three directors, 80 multiplied by 3—240 plus 1—will enable 241 shares to elect three and the remaining 559 shares no more than 6.

In some states, voting may be complicated by residential requirements. An example was furnished in the New Haven contest, where there were state residence requirements that called for 14 of the 21 directors from New England. The result showed that while

the successful slate elected eleven directors, each with 932,790 votes, the votes for the Dumaine minority of ten varied from 1,244,976 for the leading nonresident to 667,476 for the lowest New England resident.

§ 81. —— Advantages and Disadvantages.

Cumulative voting offers both advantages and disadvantages, leaving it for each management, or group of stockholders, in its particular environment, to determine which side of the scale is most weighted. Since in permissive states the corporate charter determines whether or not directors shall be elected by cumulative voting, it lies within the power of the stockholders, by majority vote where the state statute permits, to amend the charter to reject a previous charter choice.

The history of political proportional representation demonstrates the validity of the apothegm that, as reform follows abuse, so reform produces abuse. In the case of cumulative voting, it would be more accurate to say that generally, the reform sometimes produces discomfort rather than abuse, though in isolated cases, the stronger term might be employed.

§ 81a. Advantages.

§ 81a1. Representation.

The primary advantage of cumulative voting is the obvious one of affording a minority representation and voice and conversely, in preventing arbitrary and undisputed control of the board by management that holds or can summon the cooperation of a 51% vote. There can be no cavil with the contention that stockholders are entitled to representation on the board;

cumulative voting furnishes that and with it a practical means of attacking the abuse of entrenched management.

Beyond that, in actual practice, the presence of the right suffices to make its exercise unnecessary, as conversely, its absence may create a need for it. With the possibility of minority exercise of power to gain representation on the board, management is disposed to prevent its exercise by recognizing the rights of stockholders and by seeking their good will. While this tends to reduce proxy contests, undoubtedly there are many situations where stockholders are moved to seek redress when the presence of cumulative voting offers them possibility of success. Professor Williams analyzing the SEC record to 1948 found that of 69 contests, approximately two-thirds occurred in cumulative voting companies.

However, curiously enough, in the one reorganized utility in which the SEC refused to require cumulative voting—The Puget Sound Power and Light Company—two proxy fights have occurred in a ten-year period, although proxy contests have proved rare in the case of all the other SEC reorganized utility companies, practically all of which have cumulative voting.

Of course, in the really large corporation, even the task of seeking representation by cumulative voting is so hazardous and expensive as to be of little practical advantage. As the size of the corporation and the number of its stockholders tend to diminish, so, in inverse proportion, do the advantages to stockholders become more realizable. In the small corporation, where stock is closely held, cumulative voting is frequently an

agreed-upon means of affording the investor-stockholders proportionate representation.

§ 81a2. Stockholder Good Will.

To the extent that the existence of cumulative voting results in an absence of management abuse or secures stockholder representation, stockholder good will is produced.

(It may be noted that the existence of stockholder good will renders the cumulative voting process less effective, since more votes are needed by a contestant when satisfied stockholders answer the management's call even if they only serve to increase the voters present at a meeting.)

Examples of the effectiveness of cumulative voting in gaining representation for minorities as a result of proxy contests appear in the previous chapter. With cumulative voting provided for, management usually consents to stockholder representation, so that the more numerous examples of its effectiveness are not matters of record.

§ 81b. Disadvantages.

The arguments against cumulative voting will be found to be based not so much on its being an abuse, since it is difficult to conceive representation of substantial minority interests as being an abuse, but upon its availability as an instrument whereby abuse can be threatened. Of course, those of the old school who find their entrenched power threatened and who do not appreciate the satisfaction produced by good stockholder relations, suffer discomfort and grow resentful. But these are hardly reasons for discarding the remedy.

Nor is the fact that isolated cases of actual abuse may be found reason for rejecting cumulative voting provisions. Here we can find analogies to democracy.

§ 81b1. Divided Board.

The principal disadvantage of the cumulative voting scheme is that a close proxy contest will result in a closely divided board and the administration of the corporate affairs may thereafter be marked by dissension, with consequential corporate harm. We point out throughout this text the need for a cooperative board. However, in the absence of personality clashes, deep differences respecting policy, or a struggle for control, there is no good reason why men elected on various slates should not be capable of joining with each other to form a cooperative functioning board. Where insurmountable rifts exist, the conflict that ensues is the symptom of the differences, not of the presence of cumulative voting. On the contrary, the latter may be a means of reconciling the differences by giving the various parties representation and enabling them to meet and settle their differences over the directors' table.

§ 81b1.1. Examples.

A striking example of a board division, reflecting a fight for control is found in the case of the New Haven Railroad, where, in consequence of cumulative voting, the contestant elected eleven and the management ten directors. Recognizing the situation, the winner, Patrick B. McGinnis, who was elected president of the Road, said: "It's a victory but I hope to get the support of Dumaine and his directors. The railroad needs a united

board." Instead, Dumaine instituted suits to review the validity of proxies voted by McGinnis, and McGinnis retaliated by starting suits to void some of Dumaine's proxies. Later, the minority opposition largely vanished; by the next annual meeting the McGinnis interests were firmly in control.

In the proxy fight for control of International Hydro-Electric System emerging from SEC reorganization as an investment company, the head of one competing group said that it had nominated only five directors of a total of nine, because it was felt that neither group could elect more than five or fewer than three directors, with the cumulative voting. The vote resulted in a 4 to 3 division representing the two control groups. The disadvantage of a divided board in an investment company would seem so obvious that its stockholders would be moved to seek this type of investment elsewhere.

The Montgomery Ward contest gave the opposition a minority which indicated its intention of continuing the contest through the medium of its representation on the board.

In opposing the adoption of cumulative voting, although Young had previously said that cumulative voting could not justifiably be denied to stockholders, the New York Central Young management said that while it retained its basic belief in cumulative voting it had rejected it because it feared it "might invite some of the previous directorate and management . . . to seek reinstatement . . . to keep us from achieving our goals . . ." The excuse, a poor one, simply demonstrated that cumulative voting is espoused by the "outs" and rejected when they become "ins."

§ 81b2. Outsiders and Competitors.

The availability of cumulative voting promotes the efforts of outsiders and competitors to gain a foothold, the one pending final assault, the other for devious reasons. While cumulative voting representation weakens management, it does not enable a take-over unless it commands a majority vote and in that case, as contrasted with conventional voting, it leaves former management with a voice on the board. Ordinarily, a new interest coming in wants something more than a board majority and in the absence of commanding a majority stock vote that will elect a full board, it seeks to cement its ownership by acquiring 80% or more of the stock through open market or tender operations. The daily newspapers furnish such examples.

An example of the prior cumulative voting inroad was furnished when a former director of Marion Power Shovel Company solicited proxies and without prior notice to the management nominated and elected as directors three representatives of Merritt Chapman and Scott. The final step was announced by the latter a few months later when it publicly announced an offer of an exchange of stock so that it might acquire 80% of the outstanding Marion stock.

The threat posed by cumulative voting aids the "striker" who seeks to compel management to buy his stock at an excessive price. However, in unscrupulous hands every remedy is subject to abuse; the salutary stockholder's suit has largely been discredited by ulterior use. While cumulative voting arms the striker; he is nothing more than a threat unless abuses exist by which he can rally support. And if this is so, even an improperly motived stockholder can make a contribution

to the corporate good; it is for the management to end the abuse that may make him effective.

As previously noted, the problem of the competitor, though rare, must be conceded to be a difficult one. In extreme cases, the law may offer relief. For example in a suit brought by the Hamilton Watch Company versus the Benrus Watch Company, the latter was enjoined from voting its shares and thereby gaining representation on the Hamilton board because, the court found, that would impair the competitive position of the Hamilton Company.

The management of American Investment Company of Illinois successfully resisted a cumulative voting proposal, contending that it was being advocated by a competitor who sought places on its board.

§ 81b3. Other.

A principal discomfort suffered by management and board members, resulting from employment of the cumulative voting remedy, is the inability to control board membership. Election by cumulative voting may place disqualified or disagreeable men on the board. The result may range from danger to the corporation to discomfort of board members and executives. It may discourage service by qualified board members.

§ 81c. Avoidance.

Where cumulative voting prevails, effort to avoid some of its consequences include: The use of voting trusts designed to vote a sufficient number of shares en bloc to assure a majority of the board; the creation of committees of the board from which minority members are excluded in an effort to minimize their im-

portance; reduction of the number of directors, thereby requiring a larger number of shares to elect a minority; encouraging attendance in person or by management proxy at the annual meeting, again for the purpose of increasing the task of the minority; and finally, by removal of the minority elected director, where the by-laws and the state law permit, although in a number of states statutory and judicial prohibitions against thus circumventing the minority will are to be found.

§ 81c1. Stagger System.

Where cumulative voting and the stagger system concur, the principal consequence is to impair the value of cumulative voting to the minority. Other effects are sometimes curious.

For example, if nine directors are to be elected, the vote of 101 of 1,000 shares present would elect one director. If, the terms are staggered, so that three directors are elected each year, 251 votes would be needed to elect a director. However these 251 votes could elect a director each year for three years, giving it a total of 3 directors; were the election of all nine held concurrently, 251 shares could only elect 2 directors. On the other hand, 49% of the stock could elect 4 of 9 directors at a single meeting; yet it could elect only 1 of 3 by the stagger system, a total of 3 for the three-year period.

In the contest for control of Montgomery Ward, the stagger system was attacked on the ground that it was a denial of the mandatory state constitutional requirements for cumulative voting. The Illinois courts upheld the challenge.

§ 82. Practice and Procedure.

§ 83. —— Generally.

Directors are elected at the annual meeting, the time and place of which is set either by the charter or the bylaws. The latter may also fix the record date for stockholders entitled to vote at the meeting, or, as is more usual, leave it for the directors to fix the date within statutory limitations.

It is customary for the board to approve the form of notice of the meeting and the other proxy material, which requires designation of the management representatives who are to act as proxies at the meeting. The bylaws usually prescribe that the board shall designate persons to act as inspectors of election at the meeting; in the absence of such designation, statutes usually confer such power upon the stockholders present at the meeting in person or by proxy.

It is also customary for company counsel to prepare an agenda for the meeting, including the formal statements of the chairman and the text of the resolutions and motions to be offered, with provision for seconding.

The bylaws frequently prescribe the order of business to be conducted at the meeting which usually accords with customary parliamentary procedure. A typical order of business may be the following:

1. The meeting is called to order by the person designated by the bylaws for the purpose, usually the president or the chairman of the board. If no one is so designated, the board may name a chairman. The bylaws usually provide that the person calling the meeting to order shall continue to conduct it throughout; or it may call for the stockholders to elect a permanent chair-

man. Similarly, provision is made for a secretary of the meeting.

2. A report is made, generally by the secretary of the company, to show that the meeting has been properly called and that adequate notice of the call has been given.

3. The chairman calls for filing of proxies and the names of stockholders present in person for the purpose of ascertaining whether a quorum is present. It is customary for tellers at the door to get this information from stockholders entering the room and to check the information so received against the stock lists, which are present and open to stockholder inspection. Under most statutes, the stock lists have been open and available for inspection by stockholders, at the company's offices, for a period, usually ten days, preceding the date of the meeting.

The company secretary has previously tabulated the management proxies received by mail or personally solicited. With the information thus received, he is in a position to report to the meeting that a quorum is present or represented and that the meeting is competent to proceed.

When there is a proxy contest, a long period may be required for inspection and validation of proxies, for the purpose of determining the right to vote. At such inspection, contending parties are entitled to be present so that they may challenge adverse proxies and justify their own. Since votes may be changed, cast or withdrawn at any time prior to the closing of the polls—indeed until the announcement of the vote—the opportunity arises for one side or the other to seek revocations of proxies presented for examination. To avoid

such "proxy tampering," in the Montgomery Ward contest for example, the contestants produced their proxies for inspection simultaneously with an agreement that the balloting should be closed, with the sole exception that once there had been a determination of validity of proxies, either side could change its cumulation of votes. Such an agreement avoids "proxy tampering" subsequent to presentation of proxies.

Disputes concerning proxies are decided by the inspectors of election who, under some state statutes, must qualify by taking and filing an oath of office. The functions of the inspectors are ministerial; generally they are empowered only to check and determine signatures, check with the stock list and determine which is the last dated, or where dates are coincident, to declare proxies void unless other evidence of subsequent execution or mailing appears. Rulings of the inspectors may be appealed to the chairman or submitted to vote at the meeting; or recourse may be had to the courts. In the case of the Texas International Sulphur Company, for example, the chair overruled a determination of the inspectors, thus leaving the election in doubt; whereupon the contending parties announced their intention of submitting the issue to the courts.

Where there is a contest, it is customary to designate impartial inspectors; experienced and impartial ones may be hired from professional corporation companies. Where there is no contest, the inspectors are frequently company employees or counsel. They may be stockholders, and except where statutes provide otherwise—and some do—they may even be candidates for election.

4. Preceding the transaction of business, it is customary to read the minutes of the last annual meeting.

Since these and minutes of directors' meetings held during the year are usually made available for inspection by stockholders at the meeting, reading of the minutes may, on motion be waived. Some corporations make it a practice of seeking stockholder ratification of the acts of directors during the prior year. To be effective, such ratification should be preceded by a reading of the minutes affected.

5. It is good practice to proceed to the election of directors with awaiting the customary report of the president and other officers of the company, since, at least in the case of listed companies under SEC jurisdiction, the stockholders have already been furnished with a copy of the annual report for the preceding year and the formal reports can be made later in lieu of declaring a recess while ballots are being tabulated and counted.

In the Montgomery Ward contest, the opposition objected to this procedure, maintaining, with considerable propriety, that those present might be influenced in their voting if they had the opportunity of viewing their officers, hearing their reports and their answers to questions propounded to them by stockholders prior to the balloting. However, where there is no contest, the convenience of those present is served by the suggested procedure.

6. Nominations for the office of director are made—and seconded where the bylaws so require—from the floor. Any shareholder may nominate, regardless of the amount of his holdings. After all nominations are exhausted, a motion is made to close nominations, ballots are distributed, marked and collected, the polls closed on motion, and the ballots tabulated and counted

by the inspectors who make a written report of the result to the meeting.

A director may be validly elected though he is not nominated; however, the courts will seek to lend their aid to avoid any sharp practices that may work an unjust result. The law's intent is to afford a stockholder every fair opportunity to make his choice in good faith and when so acting, it will seek to avoid the nullification of his intent by reason of technicality. So, for example, a stockholder may ordinarily change his vote prior to the announcement of result, though the polls have been previously closed and balloting has ended.

The formal procedure outlined is not essential to a valid election; where there is no contest, a motion may be made to direct the secretary to cast votes for the nominees and the stockholders may act by voice vote and without written ballot.

7. In line with the suggested procedure, during the counting of the ballots the other business of the meeting may proceed; officers may make their reports, discussion may follow, to be interrupted by the report of the inspectors.

In cases of contests, such as the recent New York Central and Montgomery Ward cases, weeks may elapse before the inspectors are ready to report. Meanwhile, with the other business of the meeting completed, it recesses to await the final report of the inspectors.

In connection with "other business," it may be noted that the SEC proxy rules require that all business to be transacted by the meeting be specified in the proxy notice and despite the fact that it is customary for the notice of meeting to specify that "such other business will be transacted as may properly come before the

meeting," this permits only matters to be considered which are solely incidental to the business particularly specified.

8. Upon the coming in of the inspectors' report, the chair announces the names of the successful nominees and the terms of and the offices to which they have been elected. If the notice of meeting calls for the transaction of other business, the election of independent auditors, for example, they are similarly nominated and voted upon.

Once the formal business of the meeting has been completed, it is customary to invite questions and discussion by the stockholders, at the conclusion of which, upon motion, the meeting adjourns.

When, for one reason or another, it is not possible to complete the business of the meeting at a single session, the meeting recesses, usually to a fixed date. A recess is to be distinguished from an adjournment; the latter terminates the power of the stockholders to act in the absence of a new call for a meeting in compliance with the statute and the bylaws.

§ 84. —— Balloting and Procedure in Contested Elections.

§ 84a. Proxy Voting in General.

A proxy contest is invariably decided by the number of valid proxies received by the opposing factions. While the presence of a stockholder present in person revokes a proxy previously given (unless he confirms it), voting in person at a contested election is a negligible factor. Usually each faction will have solicited the stockholders by mail at least twice, and often more

frequently. While some advantage is thought to be gained by early solicitation of proxies, the number of stockholders who fail to be moved by a subsequent solicitation because they have given a prior proxy may and probably will be exceeded by those who execute a later proxy which revokes the previous one.

There is relatively little law on questions dealing with imperfectly executed or conflicting proxies. The problem is ordinarily a practical one and usually resolved by agreement of the contending parties. It is only when the vote is close that resolution by agreement is lacking. Usually, when the tabulation of proxies is completed, the result is decisive, so fine questions never reach the courts.

§ 84b. Formal Proxy Requirements.

The company bylaws may specify what is required for a formal proxy and, in the absence of arbitrary rules denying stockholders' freedom of choice, these will control. The basic requirement for a proxy is that it will be so executed and drawn that the intent of a particular stockholder is clearly evidenced thereby.

If stock is owned by an individual, the signature must be sufficient to establish his identity; for example, where initials are used instead of given names and the stock is registered in the full name of the holder, the proxy is nevertheless valid if it sufficiently establishes his identity.

Stock held jointly requires a proxy signed in the names of both owners.

Where stock is owned by a corporation, the proxy must be signed in the name of the corporation by an officer presumed to have authority.

Stock held in trust or by testamentary fiduciaries requires a proxy signed in such manner as to indicate the signer's authorized capacity.

Stock held by partnerships may be voted by proxy signed in the partnership name, the signature of a partner individually not being essential.

Again it is to be noted that in the few cases which have reached the courts, they have indicated a reluctance to stand upon technicalities; the burden is upon the challenger to establish a lack of authority. As a general rule, a proxy which appears valid on its face should be counted by the inspectors.

While a proxy need not be dated to be valid, the date will become important in the case of conflicting proxies since the customary form of proxy contains a statement revoking all proxies previously given. Proxies on post-card forms serve the purpose of fixing a date, where otherwise missing, by the postmark. In some cases, at least by agreement of the parties, a postmark time stamp will determine validity. Generally, the question is a practical one and the effort should be to settle it by practical means.

CHAPTER VII

Organization of the Board

§ 85. Formalities—Legal.

A director may be elected to office but is not bound by such election unless he accepts, formally or by service.

A director may resign at any time. His resignation becomes effective when and as he desires.

A director may not be removed during his term of office except in such manner or for such cause as may be specified in the bylaws; all subject to the particular state statute. This is so particularly where he has been elected by cumulative voting. In rare cases, for dishonesty or breach of trust, a court will remove or suspend a director during his term of office.

When, because of death, resignation, or other cause, a vacancy occurs on the board, it is filled by the stockholders at a regular or special meeting, unless the state statute or the bylaws provide, as they usually do, that the majority of the remaining directors shall appoint a successor, who serves until the next annual meeting of stockholders or until his successor is selected.

Similarly, when vacancies occur during the year as the result of increasing the authorized number of directors, the state statute or the bylaws determine the question of whether such newly created vacancies must be filled by the stockholders or may be filled by the directors, pending the next annual meeting of stockholders.

§ 86. Number of Directors.

The number of directors is determined by the certificate of incorporation and, in some cases, by the bylaws, within the minimum and maximum limitations prescribed by the particular state statute. Sometimes the number of directors is fixed by the certificate of incorporation; at other times a minimum and maximum number may be prescribed, with the particular number to be fixed in the bylaws. Thus, the number of directors is almost wholly optional, within the statutory limitations.

In practical operation, the small, inactive corporation will have the minimum number of directors. In New York for example, three is the specified minimum.

The National Industrial Conference Board reports that the usual board consists of seven to nine members. A director of considerable experience, writing in the Harvard Business Review, says he believes a board of 12 to 15 members is of ideal size, in that it is large enough to provide diversity of view and yet small enough to act intimately and efficiently.

A survey by the National Industrial Conference Board found that in 254 manufacturing companies, 19% reported a board of seven members, 16%, nine members, 10% were 10, 11 and 12-man boards, and less than 5% had boards of more than 15.

The large board is found in the large corporation; duPont had thirty directors; when one of the duPonts died, the board was reduced to 29. General Motors has 33 men on the board.

When the board is intended to be primarily a deliberative body, a smaller number is found. When other reasons exist for membership, such as have been previously mentioned, when absences are contemplated, and principally, when the board in a large organization consists of working executives or committeemen, a large board will be found. Thus, the number of directors on a board may be an index of management mores or organization. As the service rendered by the conventional board contemplated by the corporate concept is not needed in the small closely-held corporation, so it is inadequate for the huge one.

§ 87. —— **Odd Number.**

It might also be noted that custom dictates an odd number for a board; the theory apparently being that thereby a tie vote is avoided. As a practical matter, when a vote of the board is close, except where there is a fundamental rift between conflicting stock interests, it is preferable to have no action, to have a tie that would prevent action, rather than to have action by a majority of one.

§ 88. **Meetings of the Board.**

§ 89. —— **Need for Meetings.**

The directors of a company, like members of a legislative assembly, function as a group. Their authority is joint, their action must be collective. Individually, like congressmen, they may be granted practical privileges; actually they lack individual authority. They must therefore meet and act as a board.

This welded authority makes it manifest that meetings of the board are of paramount importance, and that substance, not mere form, is essential. The underlying virtue and the basic tool of collective decision is opportunity for free exchange of diverse views, pointed question and enlightening answer, the free-for-all give-and-take of democratic discussion that raises and levels doubts until it moulds and coordinates conclusion and conviction in the minds of the majority of a group of reasonable and intelligent men striving towards a common solution. Consequently, to act, the board must meet.

In his war memoirs, Winston Churchill said, referring to the British War Cabinet: "It was an earnest and

workmanlike body, and the advantages of free discussion among men bound so closely together in a common task . . . are very great."

The need and value of discussion and deliberation in advance of conclusion is such that directors should not bind themselves to action prior to a board meeting at which the question is to be considered. A director cannot legally bind himself to future action; nor should he attempt to do so. It is for this reason that an agent representing a special interest, even a large stockholding which may have a special purpose foreign to the best interests of all the stockholders, is not an ideal director. A director should come to a meeting with an open mind; he should have no fixed prejudgment either as the result of instruction or prejudice.

As has been pointed out, while stockholders may act by proxy, a director, being a trustee in the eyes of the law, may not do so. Similarly, a director not present at a meeting may not consent to be counted to make up a quorum, or vote.

(It might be noted that the 1955 Arkansas Legislature passed a bill to permit a person eligible to serve as a director to cast a proxy vote at the behest of an absent director.)

It is for this important reason that the practice often indulged in—"of taking a telephone vote"—is bad, if not illegal. However, there are times when the assent of an absent director is required for needed action; it is not unusual to record such assent in consequence of a telegram or a telephoned message. However, such a practice is invidious in determining a course of action that is not purely formal, since the presence of a single absent director may produce a point of view that, when

considered by the other board members, might alter the conclusion they might otherwise reach.

§ 90. —— Organization Meeting.

The certificate of incorporation or the bylaws invariably require an annual meeting of stockholders for the election of directors at a specified time and call for a meeting of directors for the election of officers to follow thereafter.

At this meeting, known as the "organization meeting", the board organizes. A chairman and secretary of the meeting are elected, unless, as is customary, the bylaws provide that the president shall be chairman and the secretary of the corporation shall act as secretary at board meetings. At this meeting, the board takes other action left open by the bylaws, such as fixing the compensation of directors, appointing committees of the board and electing officers of the corporation and fixing their salaries.

The practice of some corporations is to hold the organization meeting immediately after the annual meeting of stockholders adjourns. This serves two useful purposes: first, it effects changes in the slate of officers when changes are to be made, without delay and avoids the embarrassment of suspended authority periods of "lame-duck" hold-overs; and, second, it aids in securing the attendance of the directors at the annual stockholders' meeting, a desirable consequence from the standpoint of stockholders' relations.

§ 91. —— Notice of Meeting.

The bylaws make the necessary provision for notice of meetings. Where they call for regular meetings of

directors at a specified time, or the board, by resolution, so provides, as is customary, no other notice is necessary. For special meetings, short, informal notice is usually prescribed by the bylaws. Where notice of a meeting is necessary, it may be waived and it is customary for directors to execute a formal written waiver of notice, which is attached to the minutes of the meeting.

§ 92. —— Place of Meeting.

The bylaws also may fix the place for meetings of the directors, or may leave it to the directors to fix the place of their meetings. The certificate of incorporation may prescribe the place of such meetings. Some state statutes require meetings, both of stockholders and directors, to be held within the state of incorporation.

Where states, like Delaware, permit stockholders' or directors' meetings to be held without the state, corporate managements sometimes hold meetings outside the country. Aside from the undesirability of thus shutting off the possibility of stockholder attendance, a serious question exists whether a provision of law permitting a meeting outside the state is to be read as permitting one outside the country.

As an example of such abuse of what may be a salutary provision of law, a recent instance was found of a Delaware corporation that held its annual stockholders' meetings in Calgary, Canada, in the dead of winter. Its construction of the Delaware statute would have permitted its meetings to have been held in Siberia or Africa.

The state of incorporation is frequently selected for reasons other than those of convenience of meetings of the prospective directors. Consequently, larger corpo-

rations usually find it convenient to hold their directors' meetings in places other than those located in the state of incorporation. Usually a central location most accessible to the directors is selected. Some corporations, with activities in various states, find it advisable to have the places of meeting vary so that the directors can become familiar and keep in touch with the different operating branches of the organization, and the personnel there employed. In general, however, it will be found most practicable to hold meetings where the corporate records and the corporate executives are available to assist the board in its deliberations.

Obviously, the place at which directors' meetings are to be held may offer practical problems where there is a desire to have regular attendance of active directors of a large corporation. This is particularly true when large stockholders are given representation on a board. The situs of large stockholdings is rarely identical with the locus of the business of a corporation. This fact is emphasized when a directorate is selected for a holding company which owns operating companies in remote locations. The contribution of this factor to the difficulties inherent in the selection of directors discussed in the preceding chapter is manifest.

§ 93. —— Quorum.

A quorum is the number of directors, usually a majority, whose presence is necessary to enable a meeting to be lawfully held. This requirement is sometimes specified by the state statute, sometimes by the certificate of incorporation, otherwise by the bylaws. The latter practice is customary. In given situations, for formal corporate action, the number of directors neces-

sary to be present to constitute a quorum may be increased.

Where no quorum is present at a meeting, it is usual for the bylaws to provide that those attending will constitute a quorum to adjourn the meeting. Under certain specified conditions, the bylaws may provide that the presence of a quorum may be waived.

Where a quorum is present, the board acts by a majority of those present, except that in given situations, the certificate of incorporation, the bylaws, or a state statute may provide that the board may not act except by a majority, or at times even by a greater percentage of all the members of the board.

By way of analogy, the litigation in the case of the J. F. Byers Company may be noted. Here, at a meeting of shareholders, a majority of those present voted the incumbent board out of office. In the subsequent litigation, the management contended that a majority vote of all the outstanding stock was required for the ouster.

Though a quorum may be present at the beginning of a meeting, the authority of those present to act will cease if, by withdrawal of some of those present, a quorum is lacking at any time. This assumes importance when board members become eager to catch the 4:30 train. However, if those present at a meeting act without the presence of a necessary quorum, their action may be approved by a later and duly authorized meeting of the board.

Even though a quorum is present and the meeting is qualified to act, action should not ordinarily be taken in the absence of members of the board in connection with matters of grave moment. And this is especially

so where the action proposed tends to change or otherwise affect some policy that has previously had the tacit or express approval of the board.

§ 94. —— Attendance.

At every regular meeting of the board full attendance of board members, though not required for a quorum, is nevertheless desirable. Where a special meeting of the board is called for the consideration of purely formal matters, such as the adoption of resolutions required by law to effectuate matters or policies previously agreed upon by the directors, it may suffice to have only a sufficient number of directors attend to constitute a quorum empowered to take the necessary action. Otherwise, and particularly for regular meetings, full attendance is desirable, and, on occasions, necessary.

In given cases, the composition of the board may not contemplate the regular presence of certain members. In such cases, nonresident directors may be placed upon the board with the thought that their service will be extracurricular and that the other members will function as the meeting board contemplated by the law.

§ 94a. Examples.

A number of men on the board of the International Telephone and Telegraph Company were executives assigned to duties in distant foreign cities, and they could not possibly have been expected to attend the home-office meetings of the directors.

One of our largest insurance companies selected its board members, in some cases, for good will purposes since they lived in localities remote from the home office

of the company in which numerous policyholders of the company also resided.

A railroad corporation frequently owns lines traversing great distances and located in diverse localities. Consequently, it will draw its directors from places far removed from one another and it will not always be possible to command full attendance of directors at all meetings. For illustration, the nominees on the contestant's slate in the Minneapolis and St. Louis Railway proxy contest comprised three Chicago, one Florida, one Washington, D. C., one Joliet, Illinois, and one New York City resident, while two of the management's slate of eleven were New York State residents. The Road's headquarters were in Minneapolis.

Similarly, local enterprises, the stock of which is listed on one or more national exchanges, will frequently find its stock ownership located in places remote from the scene of operations. Such stockholders, when represented by directors of their choice, will necessarily select directors from their own locales and constant attendance of such directors may be difficult to achieve, particularly when the management does not prove wholly cooperative in facilitating their attendance.

§ 94b. Disadvantages of Absenteeism.

In discussing the qualifications of directors, we pointed out that absentee directors cannot perform the primary function of board members of contributing the value of their experience, views and opinions to discussion and decision at board meetings. And we might repeat here that the presence on the board of members who are customarily absent is not fair to other directors, who are entitled to have such contribution of views

from all the directors as an aid in coming to their individual conclusions. This is not only true but it emphasizes the inadvisability of taking action on matters of importance in the absence of members of the board. Even the absence of possible dissenters may deny to the board a germ of thought, a provocation to deeper analysis that may avoid commitment to hasty and ill-judged action.

A director who is irregular in his attendance does not acquire the familiarity with the current affairs of the corporation that is developed by continuous attendance; he is apt to find gaps in his knowledge and recollection that may impair his value as a member of a properly functioning team; when he fails constantly to do this part of his job, he runs the risk of being charged with personal liability for negligence, as we point out later.

§ 94c. Excusing Absence.

It is the practice in some companies of expecting absentees to explain their absences. In some cases, the bylaws declare that a director who misses a number of consecutive meetings, without adequate reason, shall be deemed to have resigned from the board. As a result, it is the practice of some boards to adopt a resolution at each meeting excusing absentees.

§ 94d. Compensation as Affecting Attendance.

The practice of compensating directors for attendance at meetings may have been intended to stimulate attendance, as well as to reward directors for service performed by attendance. Whether this practice has that effect, or whether the practice of paying directors

an annual fee is more effective in stimulating attendance, depends on the particular man. One director may be moved to attend a meeting because he does not want to forego the fee; another may feel that since he is not being paid he can more readily be absent.

An old-time method of inducing attendance, still indulged in in some quarters, is to provide a gross amount measured by a full attendance and to divide it equally between those attending.

The National Industrial Conference Board, surveying 4000 directors, reported that almost 40% had a 100% attendance record, that 65% attended 80% of their meetings; however, incredibly enough, a number of directors failed to attend any meetings.

§ 95. —— Frequency and Regularity of Meetings.

§ 95a. Frequency.

The time for meetings of the board may be the subject of bylaw provision. Or the latter may more properly provide that the matter may be left to the discretion of the board.

If a board is to function effectively, it must meet periodically and not too infrequently. How often the board should meet is, in many cases, an individual problem. The smaller corporation engaged in business in a steady industry will not have too much occasion for any but formal board meetings; the larger corporation must have its directors meet with some degree of frequency, if only for reports that will enable them to keep abreast of the multifarious corporate affairs. In good times, action by the directors will be called for less frequently than in times of stress, when the pres-

sures on management and the board may be frequent and compelling.

It is usual for a board to meet at least monthly. The National Industrial Conference Board reports that 50% of the boards of larger corporations meet more often than once a month; of the remainder, the large majority meet each six weeks. Many boards, particularly of small companies, meet only quarterly, the National Industrial Conference Board reports.

In the case of a small utility company, for example, where informative monthly reports of operations are prepared and sent to the directors, it should be possible to set four regular quarterly board meetings—this minimum should be needed for dividend purposes—and to hold special meetings at the call of the president when need occurs. An executive committee will also serve this needed purpose. A small industrial corporation that submits to its directors monthly sales analyses may also pursue such a policy respecting meetings.

In the larger and more active corporation, it is difficult to conceive lack of need for the directors getting together at least once a month, to consider reports, developments and problems, and to keep abreast of the corporate affairs. In the really large corporation, a single monthly meeting will not suffice, unless it is supplemented by the interim meetings of committees, or the out-of-meeting activities of individual directors. In the case of banks, where the board passes on loans, weekly meetings are needed; in the cases of the larger banks, loan committees are set up and meet frequently, as occasion requires. For example, at the annual meeting of the Corn Exchange Bank Trust Company, a

rather large New York bank, it was disclosed that the bank directors met weekly.

Generally, meetings will be as frequent as the needs of the particular enterprise dictate and the manner in which the board is organized to meet such needs. A board which holds insufficient meetings is or necessarily becomes an inactive board; however, the board that meets unnecessarily soon becomes bored and likewise tends to become a lethargic and inactive board.

§ 95b. Regularity.

The advantage of having regular set meetings is reflected in attendance. The vice of irregular meetings lies in the inability of all the directors to so coordinate their affairs as to permit full attendance at a given time. On the other hand, if a specified and regular time for meetings is set, each director can and usually does arrange his other affairs in subordination to his periodic corporate engagement.

One of the advantages claimed for the presence of management men on the board is that they are available for meetings frequently and on short notice, with the result that meetings can be frequent and yet irregular. Of course, the answer here is that we are discussing boards of outside directors rather than management committees, as we point out so frequently throughout this text.

An interesting example of irregularity smacking on nonfunctioning was found in the statement of a Montgomery Ward director who said he had received notice that there would be no meeting of Ward directors "this month" because the president was "vacationing."

§ 96. Chairman of the Board.

The bylaws of the corporation either prescribe that there shall be a chairman of the board or provide that the president of the corporation, who is invariably a member of the board, shall preside at board meetings. Ordinarily, the latter arrangement is the more practicable one, since the president has greater familiarity with company affairs than anyone else and can best coordinate the operation of the company's business with the functioning of the board. However, in given cases, it is found convenient to make a place for a president who must or should retire, to create a post to reconcile factional differences, or to put a controlling or dominant stockholder in a post from which he can survey and advise respecting operations and policies. The large corporation may have need for such a division of responsibilities.

On occasion, where more than one person is to be provided fór, we also may find a vice-chairman of the board, sometimes an honorary chairman, or a chairman *emeritus*.

Some companies are committed to the practice of having a board chairman; frequently, finding the position unnecessary, they combine it and the chief executive in one person, until occasion requires its renewal as a separate office.

§ 97. —— Examples.

Following a merger, the president of American Metal Products Company became chairman of the board to devote his efforts to "increasing and diversifying" the firm's sales.

The 65-year old president of the Home Insurance

Company became chairman of the board, his duties to consist mainly of general supervision of the fire insurance company's finances and investment of its funds.

The president of Pure Oil Company became chairman of the executive committee. The president of the Diamond Alkali Company, age 45, became chairman and took over "long-range planning and policy." The president of Southern California Edison Company was elected chairman of the board; the previous chairman became vice-chairman. The presidents of Webster-Chicago Corporation, Aero Supply Manufacturing Company and Drewrys, Limited, moved up to become board chairmen, according to a single day's announcements.

Hamilton Watch Company announced election of its former executive vice-president as chairman and president; General Cable Company announced election of a chairman of the board who would continue as chief executive officer; Nopco Chemical Company named T. A. Printon president and chairman; National Supply Company designated its former president as chairman and chief executive officer; Birdsboro Steel Foundry and Machine named its president chairman and chief executive officer, and moved its executive vice-president up to be president.

In the following chapter, discussing compensation of the chairman, we cite the case of the New York Central Railroad as an example of long periods during which there was no chairman while, at other times, when expediency required, there was an incumbent of the office.

§ 98. Committees of the Board.

The bylaws usually authorize the board to appoint,

from its own number, permanent or standing committees, and temporary or special committees. And the board usually provides for such committees, or not, in the exercise of its discretion.

A committee's tenure co-extends with that of the board which appoints it. Consequently when the term of the board or a percentage of its members expires each year, committees should again be appointed.

§ 99. —— Need for Committees.

§ 99a. Large Boards.

Where there is a large board, if it is to be expected to function efficiently, or even well, it must be whittled down into more compact working units. Some large boards, as has been noted, in reality consist of a small integrated inner core—"working members"—surrounded by a fringe of "nonresident" and "absentee" trimming.

Where the enterprise is itself large, it becomes necessary to divide up the activities of the board. In large corporations, to become sufficiently familiar with the business in all phases, a director would have to spend all of his time, becoming, in effect, a full-time participant in the business. This, in reality, converts the director into the practical status of an executive, and nullifies the objective and disassociated check-and-balance status that is so necessary between the board and the operating management.

So, in such cases, analogous to the organization of congress, the board is divided into committees, and even subcommittees. This enables particular directors to concentrate upon particular activities, in which they

become more or less expert, and concerning which they report to and advise the other directors at meetings of the entire board. Thus the board can function, and come to judgment, even where the enterprise is widespread.

Where the committee system prevails, those directors available for something more than attendance at regular meetings really become the working members of the board. The value of such an apportionment of labor lies in its making possible the actual and efficient functioning of the board. It also speeds up the receipt and sifting of factual information and data by men who, by virtue of previous training or education arising from committee service, or both, become skilled or expert on the particular subject.

So, when an insurance man is on the board, he can pass upon an insurance survey of needs and coverage and transmit recommendations to the board meeting in a fraction of the time it would take somebody else. And when directors are selected for committee service, individual qualifications needed for the particular assignment should be an important factor in determining the selection.

§ 99a1. Example.

The Continental Copper and Steel Industries announced the election of a chairman of the board, that the chairman of the finance committee had been elected president, the general counsel and chairman of the operating committee had been elected chairman of the management committee. The company announced that it had inaugurated "the managing committee type of multiple management," a system which it said is now in

wide use among large companies "where the increasingly complex problems of wide-flung business operations require the lightening of the load of chief executive officers."

§ 99b. Other Purposes.

The committee system is available to enlist the special qualifications of directors in the corporate service, even where the board is not such a large one as to involve the regular appointment of standing committees. Where, for example, the management intends to conduct negotiations involving matters outside the scope of operational activities, the acquisition of property, plant or new facilities, the appointment of one or more skilled directors as a committee to participate in such negotiations, may produce a better result.

The committee system is also available to give one director preferment, greater responsibility, over another, or indeed of the others. Such a purpose may be a valid one of taking advantage of the greater abilities, as well as the skills, of some of the directors. Oppositely, it may have for its purpose the subordination of an incompetent or a disliked director and may serve as an expedient where cumulative voting has put an unwanted director on the board.

The committee system, too, is a means of having less frequent board meetings. It enables greater attention to be given to matters than at board meetings. Because of its lesser numbers, it lends itself to better discussion and more effective decision.

A committee is often suggested as an expedient to avoid action, as a subterfuge, to put a proposed action back on the table. This is akin to the governmental

method of appointing a commission to study policy and, like the latter, can be a justified or an unjustified resort.

A committee is sometimes suggested as a means of paying additional fees to directors.

§ 99b1. Example.

An example of the use of the committee system in giving one director greater power for a proper corporate purpose occurred when a large stockholder in an industrial corporation having a board of nine members sought additional representation. The board members and the management were not unwilling to grant the request but they were unwilling to increase the board, fearing that a board of more than nine members would become unwieldy, and they were unwilling to have any member resign. The compromise devised was to appoint an executive committee on which the representative of the larger stockholder would be one of five, thus giving him in effect the same voice two members of a ten-man board would have had.

§ 100. —— Disadvantages.

While the advantages, indeed the necessity of the committee system in the larger corporation is obvious, it also has potentialities of disadvantage. The first of these is that by too much service, the director may begin to think and feel like a part of management and thus lose his identity as a director, with its many consequences.

The second is that a committee, particularly an executive committee, may tend to supersede the board.

That "knowledge is power" may be bromidic, but it furnishes the basis for conclusion that when committee

work is highly concentrated, the committeeman who knows will ultimately do the board's thinking on his subject. Likewise, he inclines to become dictatorial and defensive in his conclusions, and the other board members will unthinkingly tend to adopt the committee's conclusions without adequate individual consideration. Also, committee assignment can have the effect of inducing lethargy in the committeeman as to matters not within the scope of his committee work. In such cases, individual directors may find their knowledge of the business generally restricted to the particular phases with which they have dealt.

Here, too, the federal congress furnishes examples of men of long congressional service who ultimately make no attempt to know anything about the subjects not within the scope of their principal committees. And while in a large body, like congress, this will not prove harmful, in a small restricted group of directors, in lieu of the mass deliberation and conclusion so essential to corporate action, one is liable to find single minds functioning for the whole.

A third possible vice of the committee system, is the possible tendency to build up a factitious individual authority in directors that infringes upon executive authority. This may readily cause directors to interfere within the scope of executive jurisdiction. It also makes for excessive contact between directors and subordinate executives, with consequent possibility of infraction of higher executive authority.

Manifestly, these disadvantages can readily be overcome by diligent attention, vigilance to avoid the danger of superseding the board or of offending its members.

Particularly useful in avoiding vices of the committee system is the practice of rotating membership on committees. While a committee may be reappointed each year, all of its members should not be automatically continued. Some continuity of membership may be needed from those with special qualifications, but service should not become patronage or autocracy. This practice also has the advantage of educating additional board members respecting the special problems handled by the committee.

§ 101. Types of Committees.

§ 102. —— Executive Committee.

The top standing committee of a board is the executive committee. Its proper place is to provide the equivalent of an immediate special board meeting for operating management, between regularly set meetings of the board, without calling all the board members together.

The bylaws invariably provide that the executive committee shall have all the powers of the board itself during the *interregna* between board meetings, although the action of the executive committee is necessarily subject to the overriding power of the board. And in some corporations, the bylaws provide that executive committee action must be ratified by the entire board at its next meeting.

§ 102a. Advantages and Disadvantages.

In the larger corporation and even in the smaller one, where it is difficult to get board members together quickly, an executive committee is a necessity. Where

the committee system prevails, it is the keystone of the structure.

The National Industrial Conference Board survey of 1945 reported that of 535 companies, 197 had an executive committee; that over 60% of the corporations with assets of $50 million or more had executive committees.

In small corporations, the executive committee also has its uses. The discussion of advantages and disadvantages of committees in the preceding section has particular application to the executive committee and need not be here repeated. Both the advantages and the disadvantages, when present, are intensified in the case of the executive committee.

As example of the latter, the fact is that the purpose of having an executive committee is not infrequently ulterior. In some corporations, particularly where executives dominate the board, the executive committee generally will consist of executives who in practical effect and consequence function as and in lieu of the board. Such a practice can effectively reduce board action to a desired minimum of form.

Even where it is not intended that the executive committee supersede the board, care must be taken to avoid such a result, particularly where the executive committee membership comprises a majority of the board. In such case not only should the executive committee not act, except in emergencies, but its recommendations should be limited to essentials where it can clearly function more efficiently than can the board.

For example, an executive committee should not make a dividend recommendation, particularly when it com-

prises a board majority, since, as a practical matter, it thereby precludes board action.

For these reasons, an executive committee consisting of a majority of the board will find itself hampered and restricted. It would seem the better practice to limit its number to less than a majority, else it is bound to render board action a mere token.

Of course, wherever there is an executive committee, the president or board chairman is a member, and the balance of its membership is usually restricted to the more active and vigorous directors, and usually those closest to the executives. Obviously, this also tends to relegate the board itself to somewhere in the rear ranks, particularly since the average director is not inclined to struggle for the opportunity to increase his burden of work and responsibility.

§ 103. —— Other Committees.

There may be other standing committees provided for by the bylaws, such as finance, audit, personnel, pension, salary, policy or investment committees. The title of the committee generally indicates its functions. The needs and policies of the particular corporation, and its methods of organization and functioning, will determine what standing committees of the board, if any, it appoints each year.

From time to time, special committees may also be appointed for the consideration of temporary or special problems not within the scope of standing committee assignments.

The 1945 survey by the National Industrial Conference Board reported: of 535 companies, 59 had salary or compensation committees, 42 finance, 29 auditing, 24

bonus and pension, and 65 other regular committees; that 264 had special committees.

Committees of the board are not to be confused with operating management committees. The latter are operating committees. Obviously, the functions of the operating management and board committees are as diverse and, at the same time, as interrelated, as are the respective functions of operating management and the board. Board and operating management committee members may find it helpful to sit in at each other's meetings, and otherwise cooperate functionally, where particular operations and policies impinge upon each other.

§ 104. Formalities.

A committee, other than a major one, may consist of one or more members. If the size of the board and the number of committees permit, a standing committee should comprise no less than three members. Thus, the intimate knowledge and experience of the committee will be passed along and perpetuated in spite of changes of personnel.

Committees are usually appointed and reappointed each year, when the board organizes and elects officers.

§ 105. Functioning.

The work of committees is frequently, in practice, the work of committeemen, conducted informally and under auspicious circumstances. Nevertheless, many committee functions lend themselves to formal action at formal meetings. Indeed, the work of the executive and finance committees generally needs to be so con-

ducted. In such cases, meetings of the committee may be held and conducted like board meetings.

Where the proceedings of a committee are formal, they should be recorded by the keeping of minutes, which, with committee reports, may provide better bases for liaison between the committee and the board than can be assured by wholly informal action and reports.

Standing committees should adopt rules, however informal, for regularity of meetings and prompt reports. An executive committee must necessarily report to the board at each meeting on all action taken by the committee since the last board meeting.

An audit committee, for example, should fall into a regular routine. If its job is merely to audit annual or semiannual statements, it should meet regularly, semiannually, as soon as the figures are ready, and report to the board immediately following completion of its work.

A committee charged with the duty of formulating a long-range program may need an indefinite period of time to complete its work. However, as a self-defense against doing nothing, since something need not be done at once, it should make periodic interim reports.

The practice of a committee automatically reporting "progress" to cover inaction, is a bad one; a report of "progress" should be accompanied by factual data defining and proving the term.

Needless to say, a committee's work should not be perfunctory. A standing committee may properly be inactive over a long period of time, but when any committee has a job to do it should do it promptly and thoroughly. This is especially important in the case of

committees since board members should give heed to committee recommendations.

A conscientious board member can investigate a matter thoroughly, for himself at least, and will do so though the other board members are lax. But he cannot know that a committee is investigating superficially or not at all; he will rely on its report in good faith and without opportunity to observe or fill in the hollow core.

CHAPTER VIII

Compensation of Directors

§ 106. Legal.

The law presumes that a director serves gratuitously. Therefore, it becomes necessary for stockholders to fix directors' compensation if they are to have any, or to give the directors authority to do so themselves. Consequently, the common practice is to have the bylaws authorize the directors to fix their own compensation as part of their general duty of fixing the salaries of the executives.

§ 107. Evolution of Present Practices.

The legal assumption that directors serve gratuitously was a natural concomitant of director-stockholder concurrence in the small local enterprise, in which directors had the incentives of stockholders to serve the common interest. But as the cycle has replaced the stockholder-director with separation of ownership and management,

so the legal concept of no compensation for directors has given way to the practical recognition of the need for direct monetary incentive.

In the era of the nineteen twenties, the $20 gold piece was the apparent basis of compensation. In fact it was a mere honorarium; the director's true perquisites were the opportunities which graced the office. Directors' incentives were many and included lucrative "tips"—advance information—concerning proposed stock manipulations, consolidations, mergers, stock-split-ups, opportunities to be included in preferred stock lists and to share in ground-floor stock subscriptions.

The reaction to these abuses followed during the thirties in the form of government investigations and consequent prohibitory legislation. Stockholders' suits followed many of these revelations and a number of directors and corporate executives paid personal penalties.

With under-the-table perquisites all but cut off, new incentives had to be found to induce reputable men to accept directorships, to give the needed service and accept the responsibilities. But the incentives were lacking; the direct, over-the-table directors' fees had never been intended to be compensation for the effort involved in doing an honest job, or the risks involved in not doing one.

The consequence, whether management sought directors free to exercise their honest judgment, or those who would conform to "rubber-stamp" practices, was common. It became increasingly difficult to get suitable men to serve as directors.

Operating managements attempted to lessen directors' liabilities by getting legislative permission to indemnify their directors against stockholders' suits and,

also, by obtaining state legislation to curtail the stockholders' remedy by suit. Concurrently, management sought to increase the directors' monetary compensation.

Three methods of compensating directors are in vogue: the first, the customary one of paying a stated fee per meeting, the second, the method of paying an annual fee, and the third, a hybrid, of paying an annual retainer, plus a stated fee per meeting.

In giving impetus to a more enlightened concept of a director's duties and potentialities, New Deal agencies, the SEC and the courts, in utility and other reorganizations, encouraged the practice of fixing an annual fee basis for directors' fees, and the National Industrial Conference Board reports in 1953 that in a survey of 134 companies, the annual fee practice was found to have increased from 5% in 1938 to 22% in 1953.

The NICB survey of 233 manufacturing companies shows that fees ranged from a low of $20 in the smaller companies to a high of $500 in the case of a large steel producer; that one-third of the companies paid $100 and 16% $50; that the annual fee ranged from $1,000 to $6,000 per annum; of approximately 40 companies, two paid $6,000, eight $5,000, two in the $3500 range, 13 in the $2500 range and 15 in the $1,000 to $1,500 range. Where the annual fee is paid as a retainer, the set meeting fee generally is $100.

§ 108. —— Company Executives and Employees.

Since in the case of officers and employees serving as directors the legal presumption of free service is heightened by the fact that they are being otherwise compensated, it is necessary that the bylaws or the reso-

lutions of the board fixing directors' compensation make express provision applicable to such directors.

The question of whether officer-employees should also receive directors' compensation is a debatable one. One school of thought suggests that in accepting a directorship, an executive assumes additional duties and responsibilities, and is, in consequence, entitled to additional compensation. What would seem to be a sufficient answer to this contention is that directors are not paid for the responsibilities they assume; they are compensated for the time they expend. If they were to be paid commensurately with the responsibilities they assume by accepting the office, bank directors, for example, would have to be paid large sums in view of the heavy responsibilities they assume, instead of the token sums they accept to supplement the prestige which induces them to accept the posts. The proof that the basis of payment of directors is time is found in the fact that the standard measure of payment is attendance at meetings. That being so, since company employees are paid salaries for their time during business hours, and since attendance at directors' meetings involves no added expenditure of time, it would seem proper that company executives serving as directors should receive no added compensation in that capacity.

This seems to mirror the prevailing practice. According to the National Industrial Conference Board survey, two-thirds of the companies did not pay officer-directors additionally for board service; of the one-third who do, 25% pay the insider less than the outside director receives.

Regardless of the academics of the arguments pro and con, there will be individual situations where equities

or expediencies suggest payment of compensation to officer-directors. The amounts of money involved are inconsequential in the light of the morale of the director, which is all important. So, as should invariably be the case where no matter of deep principle is involved, the practicalities should govern.

§ 109. —— Committeemen.

Where the board functions through the medium of committees, unless an annual fee has been fixed with such committee service in mind, the directors rendering such extra service should be compensated for committee service. The basis of compensation where the committee system prevails and the committee meets regularly and formally can be on the per meeting basis; where, however, the committee is a special one and meets informally, some other fair measure must be devised.

The NICB reports that in only 7% of the companies surveyed were extra fees paid for service on committees and that $100 was the fee commonly paid for attendance at each committee meeting.

§ 110. —— Expenses.

It is likewise customary to reimburse an out-of-town director for his out-of-pocket expenses in attending board or committee meetings. Similarly, any other unusual out-of-pocket expenses of directors incurred in connection with company business, for example, on inspection trips, should be borne by the company.

The NICB reports that seven out of eight companies reported that it was the practice to reimburse directors for expenses incurred in attending meetings; that some of those not so reporting state that they took the ex-

penses in consideration in fixing the amount of the directors' fees.

§ 111. —— Extra Service.

Where a director is employed or retained by his corporation for additional service, particularly if it be within the scope of the director's personal business or profession, he is entitled to reasonable or agreed compensation for the additional service, the same as any stranger would be. And such added compensation in nowise affects his right to be paid for his services as director, in common with the other directors.

Such relationships are common; the lawyer, the banker, the accountant, the consultant on the board frequently renders extra and professional service. We discuss the implications of such relationship in other connections later. Here, in considering the director's compensation, we need only say that the existence of such a relationship poses no problem.

When, however, a director undertakes to render service outside the scope of his duties as a director which falls short of a professional or business retainer or employment, another situation is presented. A question might arise if, for example, a member of the board, retired from active business, were asked to make a study of employees' pension and insurance plans and report thereon.

In such case, unless there was an understanding before the services were rendered that the extra service should be the subject of extra compensation, the law would presume that neither the corporation nor the director intended that the extra service would be paid for. Under those circumstances, the director would not be

entitled to extra compensation, even though his task had taken him afield.

As a practical matter, there should be little difficulty in determining whether a director is being called upon to render service within the scope of his obligation, or special service requiring special skill. The last is generally the standard; when an insurance survey is needed, a specialist is asked to do the job; if one happens to be on the board, the task falls within his orbit and he should be paid as an outsider would expect to be paid.

The fact that the performance of the assigned task involves homework is no standard; homework is part of the director's job, though for practical reasons, the attendance at meetings may be the measure of compensation.

In most cases, there should be no difficulty in determining whether the job lies within or without the periphery of the director's duties for which the stated fee is adequate compensation.

§ 112. —— Compensation of Chairman.

As we have pointed out in an earlier section, the post of chairman of the board is a somewhat ambiguous and frequently an unnecessary one since, except in the larger corporations where there are more than enough duties to go round, the chairman's duties embrace only those of presiding at board meetings, a duty which may as readily, and perhaps more readily, be performed by the president. On the other hand, as we have also pointed out, in particular situations, a retired president can render valuable service in an advisory and supervisory capacity and has the physical and mental vigor to do so.

Consequently, in the case of the board chairman, each situation must rest on the individual facts and no rules can be formulated for compensating a board chairman. Sometimes his retirement pay and allowances suffice for his needs and he wants the post in order to retain an interest and prevent vegetation. Other times, he is really needed and having retired at a vigorous age, is capable of and is called upon for a reasonably full day's work. So each situation is *sui generis.*

§ 112a. Example.

To illustrate the variances, the following may be enlightening:

The late Senator Chauncey M. Depew was chairman of the New York Central Railroad Board from 1898 until his death in 1928 at the age of 93. The New York Central had no board chairman for the next 25 years. Thereafter the retired president became board chairman at a salary of $10,000 a month. When he retired, no chairman was appointed. In the New York Central proxy contest, Young, the contestant, offered to serve as board chairman at a nominal salary. It was disclosed that he was receiving $20,000 per annum as board chairman of the Alleghany Corporation and that he had received $7,500 per annum as chairman of the Chesapeake and Ohio Railroad.

§ 113. Rationale of Compensation.

§ 114. —— Inadequacy.

Generally, directors' compensation is fixed by the board in consultation with management. Frequently, the rate of compensation is determined by industry

practices, or by community habits. Rarely are active and conscientious directors overcompensated. The more conscientious the director, the more time and effort he gives his job, the more he thinks about its problems in his spare time, the more he worries about them when things get difficult. On a basis of time alone and what he receives in compensation for it in his principal occupation, the average director of standing and repute does not begin to be adequately compensated by the prevailing rates of directors' fees.

At a meeting of the stockholders of the Corn Exchange Bank and Trust Company of New York, a stockholder suggested that the $50-a-meeting fee paid the bank's directors was inadequate; thus demonstrating even stockholder's recognition of the fact.

It is well that directors should not be sufficiently compensated. Anything that may induce the man unduly to seek the job might tend to induce him to offer operating management some modicum of his independence in order to retain his post. Particularly is this so when, by becoming lax in the performance of his duties, the director's compensation may, with management consent, become proportionately more lucrative.

This, too, is an argument against the introduction of the practice of having professional or public directors. The temptation of a sinecure, carrying a lucrative salary, carries with it dangerous potentials in the case of a fiduciary.

It seems the better course that directors should be underpaid in their direct compensation, leaving it to other legitimate incentives to iron out the inequalities.

§ 115. —— Sufficiency.

At the same time, the director's compensation should not be too niggardly, for a number of reasons, largely psychological. Men are curious animals; the man with ten million dollars will resent being denied one hundred dollars as much as if he needed it; the director who turns practically all his director's fee to his least favored charity, the United States Internal Revenue Department, will resent having his stipend cut from $100 to $75.

The director who gets no fee, or such a small one as to be none at all, feels no duty to the corporation. When he gets paid, whether the money means anything to him or not, he feels a concurrent obligation. A token awakens a token sense of obligation; the average man who takes stockholders' money feels obligated to make at least an equivalent return in attendance and service.

It is for this reason that when conditions get bad and stockholders are denied dividends, that it is unwise to attempt to economize by reducing directors' fees which undoubtedly were not increased because dividends were being paid. Times of stress are the times when the stockholders need the best that directors can give them; they stifle those impulses by gestures that bear the profile of ungratefulness.

§ 115a. Examples.

The effect of niggardliness in fixing directors' fees was demonstrated by a management that, having had new director personnel forced upon it, sought to dampen the enthusiasm of the new members by fixing a nominal director's fee for attendance at meetings. By the end of the year, the management was firmly

fixed in the managerial saddle since the record of attendance of the new directors had become lamentable.

An amusing story is told by a director of a utility company which, in his judgment, as a result of many years of habit, paid an insufficient annual fee. The director, who served on a number of boards, suddenly broke in at a meeting with the suggestion that the annual fee be increased, saying, as his reason:

"My grandson asked me the other day to tell him what boards I served on and how much I received in fees on each one. I did so and when I came to this company and told him what it paid, he interrupted me to say: 'Gee, that must be a pretty poor company'." The management, figuring that if a child came to the conclusion that an inadequate director's fee reflected on the standing of the company, the business world might take a similar view, supported the motion and the rate of compensation was increased. (It might be noted here that the compensation paid executives has a similar reflective effect.)

§ 116. —— Other Incentives.

The fact is that the average director who is found desirable by the average corporation is in a tax bracket where the amount of director's fees is of little but psychological importance. He must find incentive to serve in other sources.

§ 116a. Stock Interest.

There are legitimate incentives that in given cases induce men to serve as directors, although the direct compensation be inadequate.

The most direct, the most natural, and the most legiti-

mate, is the protection and enhancement of the stock interest of the director himself, or of his immediate family, or of other interests he directly represents.

A man will give full, voluntary service to protect his investment, to increase its value and the dividends he may expect to receive therefrom. The motive of the director in such case is coextensive with the interests of the main body of stockholders whom he is undertaking to serve as a trustee. This concurrence of personal and fiduciary interest emphasizes the value of competent ownership control to which we have referred in prior pages.

§ 116b. Others.

§ 116b1. Tangibles.

Success evidenced by directorships in the economic field may bring other recognitions, honorary degrees, invitations to make addresses, and even political posts. Who is there competent to derogate the measure of another's standards of accomplishment?

There are still other tangible incentives. Many men welcome the opportunity to serve upon boards for the business contacts and relationships which such service promises, not only directly with the corporation, but also with their corporate associates, as well as outsiders, impressed or otherwise influenced by the corporate relationship.

A lawyer, a banker, an accountant, an insurance man, an engineer, may find professional relationships growing out of his directorship, directly or indirectly. A business man on the board may, and usually does establish future business relationships as a consequence

of his service, not only, on occasion, with the corporation but also with fellow members of the board.

§ **116b2. Intangibles.**

The second group of legitimate incentives to directors is found in the intangibles that, even in this mercenary age, still move men of integrity.

A man may be impelled to serve as a director, through loyalty, friendship or long association. The prestige of a directorship may not be inconsiderable if the corporation itself is of good reputation and standing. The cultural advantages of association with successful men of repute on a board; the expression afforded by a constructive outlet for one's initiative and energy; the feeling of exercising power; the satisfaction of contributing to the doing of a good job; the opportunity for public service; all these are valid and powerful incentives, particularly to men to whom money has come to have only incidental value.

Most successful men of affairs continue to work for money only because it still marks a measure of commercial success; other factors—that, for instance, of still "playing the game"—may readily take its place. With men of directorship caliber, their morale still unshot by inroads of dialectics of class warfare, there still survives the idiosyncrasy of a bygone day, called "work satisfaction." "It's the job that counts," ***Fortune*** quotes Alfred Sloan of General Motors as saying.

And to appreciate the value of such rewards as a prophylaxis against senility, one need only know materially successful senescents who have withdrawn completely behind the façade of their fancied pecuniary security. To paraphrase Justice Holmes, a man may

begin a pursuit as a means of keeping alive; he may end by following it so he does not live the living death of boredom.

Earlier, in discussing the presence of former executives on boards, we pointed out the advantages of obtaining the participation of men who had retired but still found themselves physically and mentally vigorous. Such men have incentive to serve on boards of companies other than their own; service on three or four boards may well constitute a retirement program with mutual benefit to the director and the companies he undertakes to serve.

CHAPTER IX

Meetings of the Board

§ 117. Formalities—Legal.

Concerning the formalities of conduct of meetings, a brief word may be said.

While in executive session, only members of the board

attend its meetings; otherwise, anyone may be present by invitation or with the consent of the board.

In general, the conduct of directors' meetings is governed primarily by the bylaws, although in special instances, the state statute may be found to contain requirements or prohibitions. The bylaws usually prescribe the order in which business shall be conducted, following accepted parliamentary routine, which prevails in the absence of specific contrary provision.

§ 118. Presiding Officer.

The chairman of the board, if there be one, or the president, if there be no designated chairman, presides. The bylaws usually provide that the president shall be *ex officio*—by virtue of his office—a member of the board. Again, the bylaws usually provide that in the absence of the president, a vice-president shall perform his duties. If a vice-president is not a member of the board, the board designates its own chairman.

Where there is a board chairman, it is important that there be coordination between the president and the chairman of the board in preparing agenda for meetings and arranging for their conduct.

§ 119. Secretary.

It is usual for the bylaws to provide that the secretary of the corporation shall act as secretary at board meetings and he may do so even though he is not a member of the board. In the absence of a specific bylaw provision, the board may designate its own secretary, who may be a member of the board, or someone else, frequently the secretary of one of the executives.

The importance of the secretary lies in the necessity of keeping minutes, a record of the proceedings of the board.

§ 120. Minutes.

Even though the secretary be a stenographer, it is not customary that a verbatim report of proceedings before the board be kept. And properly so, since such a record would invariably act as a check upon the free flow of discussion that is so essential to the proper functioning of a board. Every newspaper reporter can testify to the constrictive effect of a pencil and pad upon the subject of an interview.

Nevertheless, the record of board proceedings should be something more than a bare statement of action taken. The substance of conclusions reached and, at times, a summary of opinions, contentions, and other facets of free discussion, even though not followed by immediate action, are often found valuable, but within practical limits. This is particularly true when questions, once discussed, recur for action. Frequently, policies are ultimately fabricated and formulated through preliminary discussions, sometimes over a long period. And such record of proceedings at a meeting at which some directors are absent is essential to keep them up to date. For similar reasons the record should not stress anonymity to a point of ambiguity. And it is extremely important that dissent be recorded; directors' ultimate liability for negligence or bad faith may rest upon such a record.

A well-kept and comprehensive set of minutes is bound to be the best evidence of what occurred at a meeting, although it cannot and should not be a com-

plete record of the discussion. As a legal matter, such a record is binding upon those who attended the meeting, particularly when, as is customary, it has been attested by the customary motion to approve the previous minutes at the following meeting. Obviously, after directors have attended a series of meetings over a period of years, no scientific demonstration of the unreliability of recollection is needed to implement the conclusion that a director cannot rely upon his memory of what occurred at any given meeting.

Even a well-kept set of minutes can be supplemented to advantage by contemporaneous notes kept by a director. When minutes are not carefully or accurately kept, when oral reports are made at the meeting without being sufficiently recorded, or where, in other respects, minutes are not comprehensive, a director's personal notes may prove of considerable value later, if and when questions arise.

The reliability of minutes is invariably attested through the practice of placing a copy in the hands of each director, so that at the following meeting, as the first business, the minutes of the previous meeting may be offered for approval and a vote taken thereon. If the minutes as submitted by the secretary, do not, in the judgment of each director, correctly represent the proceedings of the previous meeting, a motion to correct them is made and the necessary corrections noted.

It is an excellent practice, where a sufficient period elapses between meetings, to have the secretary submit a draft of the proposed minutes to each of the directors so that each may submit written suggestions for corrections to the secretary. This should be done promptly following each meeting, while the directors' recollection

of what occurred at the particular meeting remains fresh in their minds.

§ 121. —— Of Previous Meeting.

This practice makes for a saving of time and effort at the subsequent meeting, when, as is customary, a motion is made to approve the minutes of the previous meeting. Such a procedure makes it unnecessary to read the minutes since all the directors have previously had a copy of them.

It might be noted that since an affirmative vote on the motion to approve minutes of a previous meeting attests their correctness and since a director who was not present at the previous meeting is in no position to pass upon such correctness, he should properly be recorded as "not voting."

It might also be noted, in passing, that though an absent director does not vote to approve previous minutes because of his absence, he should nevertheless familiarize himself with their contents, for a knowledge of what has taken place in his absence is essential if there is to be no gap in his chain of knowledge and recollection.

§ 121a. Dissent.

On occasion, an absent director may want the minutes to record his dissent from action taken at a previous meeting; such an occasion, it is true, would be infrequent; it might occur, however, when a vote was taken on an important matter, so grave that the absent director would want his dissenting stand made a matter of record.

§ 121a1. Examples.

A director unavoidedly absent when a vote was taken to approve a labor contract that granted an increase that the company could not afford to pay since it was impossible to add the cost to the price and without such an increase, the company could only manufacture at a loss, properly insisted that the minutes of the subsequent meeting record his dissent; an absent director who desired to protect himself against the previously authorized declaration of a dividend properly made a similar request.

§ 122. Preparation.

§ 123. —— By Management.

It is hardly necessary to say that the conduct of meetings of the board should be neither casual nor desultory. On the contrary, meetings should be planned in advance and so planned as to provide a comfortable and cheerful meeting place and the presence of necessary physical facilities and comforts, all to the end that the board members may feel that theirs is a necessary and important task and that they may be stimulated to give it the necessary time and attention.

The advance planning by management should, of course, go beyond this; it should be designed to adequately inform the directors, to give them ample opportunity for discussion, deliberation and decision, to hold their interest and to induce them to employ their talents in the full. The details of such planning appear hereafter.

§ 124. —— By Directors.

The directors, too, owe management and each other

the duty of advance preparation, first, to generally inform themselves respecting the company and its affairs, the industry and its special problems, so that they may have an adequate background against which to view and determine the particular problems presented at a meeting, and second, to read and study the agenda and supporting data management provides for consideration of the questions to come before the particular meeting.

§ 125. Time for Meetings.

The primary physical requirement for the full performance of the director's duty is time. The formal and practical rules and conditions under which meetings of a board are held, as noted, must be conducive to discussion, consideration and conclusion. A board cannot do justice to its obligations in an atmosphere of haste. There must be an ample number of meetings held with sufficient frequency, and enough time must be allowed at each meeting for inquiry, communication, consideration and conclusion.

The time to be allotted for each meeting must be determined by the needs of each enterprise and the efficiency with which the board approaches its problems. Informed, experienced directors usually require less time for discussion and solution of business problems than do untutored novitiates. Here, the age and experience of the board is an important factor, as is the competence of management and the efficiency of its preparation for meetings.

Once a board has set its long-range sights on a program, once it becomes acquainted with the problems which come before it, once it has become accustomed

to working in unison, the time needed to dispose of all but extraordinary and nonrecurring problems is inevitably shortened. Like persons in a poker game who play frequently and regularly, who come to know each other's habits of play and the bent of each other's mind, directors, through experience, learn each other's trends and predilections and thereby avoid unnecessary discussion and argument.

Of course, the greatest saving of time is effected—but at the greatest possible cost to the corporation and the stockholders—when the board members are or become inactive.

Activity, inquiry, question and answer, debate, argument and rebuttal are time consuming. But they are requisites if board meetings are not to prove mere formalities. Likewise, the addition of new blood to the board means necessary additional time to educate and age the novices. But here also an essential purpose is served.

Again, here, as in many other situations, no ritual will serve; only experience can demonstrate what variations of time a properly acting and active board will need to do its job.

§ 126. Agenda.

The business of the meeting should be based upon a prepared agenda which should be supplemented by such figures, data and other information as the board members may be expected to need in their consideration of the questions to be presented. The agenda is a means by which competent executives place before the board matters calling for board consideration.

An agenda should pick up all matters left suspended

or unfinished at prior meetings, or which require report at the subsequent meeting. Minutes and agenda should form an unbroken chain.

An adequate agenda may also bring to the board's attention matters or developments requiring, justifying or provoking thought and discussion by board members, or upon which operating management desires the board's reactions. This may properly be done even though definitive action is not called for at the particular meeting. In this category fall reports of progress or failure concerning matters previously discussed by or acted upon by the board.

On occasion, the agenda may also include—and this is important—matters to be rejected. This latter practice is a means by which intelligent executives properly compel a board to share their responsibilities and assume a fair portion of them.

A correctly prepared and comprehensive agenda can do much to shorten time consumption at a meeting. If, for example, it contains a succinct statement of the important facts that should govern the determinations to be reached, it will avoid unnecessary questioning.

The agenda should be made available to directors a sufficient length of time before the meeting to permit them to study it and to make such collateral investigation of proposals as they may think needed.

§ 127. —— Recommendation.

The factual statement of a management proposal should be followed by a recommendation of the operating department affected. An operating management recommendation will be adverse when the matter is one placed

before the board for rejection, as suggested in the preceding section.

§ 128. —— Presentation Should Be Fair.

The factual presentation in an agenda should be two-sided. It should not be slanted to favor the recommendation. An operating management that so presents questions to the board as to arouse suspicion of the fairness of its presentation is not only being unfair to the board members, but is paving the way for its own ultimate discredit.

A fair and adequate presentation, in many cases, will frequently make board action possible without discussion. In such cases, what appears to be automatic acquiescence in operating management's recommendation will not be the mark of a supine board but will testify to the competence of the executives.

§ 129. —— Supplements to Agenda.

§ 129a. Reports and Statistics.

An agenda should be supplemented by current financial statistics and reports of operations, preferably on a comparative basis with the necessary breakdowns and supporting data, so the board can intelligently review operations.

The board's function of reviewing operations is an important one. Yet, too often, instead of permitting reports of current and past operations to provoke analysis and conclusion as they should, board members simply consider them indicative of their prior right to be informed of company matters and bundle the reports into their brief cases without consideration, for inclusion in their personal files.

If such reports are what they should be, they will be comprehensible. They should enable the directors to get a perspective of operations, their scope, how they are going, and why. They should be as simple as possible and, conversely, not unnecessarily elaborate or complicated. Too much information can prove more confusing than too little. Too little information may provoke needless doubts and inquiries. Complicated reports may readily prove discouraging to all but the most persistent director; ambiguous ones may serve the purpose of concealment rather than disclosure. Information ineptly compiled, or too cleverly assembled, may carry an odor of incompetent or dishonest operating management. Certainly, it will not mark a frank and cooperative one.

Nor is an unwillingness on the part of executives to have board members take from the board room data and reports for subsequent inspection and study, a healthy mark of cooperation between operating management and the board, if it does not spell something more drastic. It is practically impossible for directors to encompass the amount of information, verbal and written, they should receive at board meetings; "homework" is frequently a required curricular activity of the director who wants to do his job of review adequately.

§ 129b. Attendance of Officers.

At meetings, the agenda and the accompanying reports, should also be supplemented, where convenient, by the attendance of the necessary executive and subordinate officers who are in a position to supply additional information sought by the board.

In addition, this practice enables the board members

to become acquainted with the operating personnel. This latter course builds the essential human relationship between the board, executives and managerial personnel so important in the establishment of confidence, mórale and consequent teamwork between the executives and the directors.

§ 130. Procedure—Formalities.

In the conduct of meetings the rules of parliamentary procedure, to be found in Cushing's and other manuals, govern. However, it is hardly necessary for a director to be a parliamentarian, who is as much needed at a decently functioning directors' meeting as is a sea lawyer on a ship or in an army camp.

Where, on rare and unavoidable occasions, tempers fray over the directors' table, even then it should suffice for directors to know only a few of the fundamentals of parliamentary procedure. For example, it should suffice, for all practical purposes, if a director knows:

That a pending motion precludes the introduction of another, except:

(1) A motion to amend the previous motion (which, if accepted and seconded, is voted on before the previous motion);

(2) A motion to close the discussion and vote—"to move the question";

(3) A motion to table the pending motion—to adjourn its consideration for a specified or indefinite time; and,

(4) Finally, a motion to adjourn the meeting, which is always in order, although not always the height of courtesy.

§ 131. —— Seconding a Motion.

Although parliamentary procedure requires a motion to be seconded before it may be discussed or considered as a motion, courtesy, reciprocity and cooperation, all essential oils for a smoothly operating directors' mechanism, require that any motion offered by a director be seconded, if not by another director, then by the chairman.

There are a number of other reasons for this. The fact that no one is prepared to second a motion, when made, is not necessarily evidence that, when put to a vote, the motion will fail. The discussion, which is the *sine qua non* of the directors' function, may well convert a radical and unthinkable proposal into an acceptable one, in its original or modified form. Short of this, one can never tell what valuable ideas and conclusions will emerge from relevant and well-informed group discussion. Every director is entitled to an opportunity for discussion of his seriously made proposal, and every other director should be vigilant to assure it, although, in exceptional situations, the only protection afforded a board from a discursive director may be his inability to find a seconder for his motions.

That a director may ultimately want to vote against a proposal is no reason for refusing to second a motion for its adoption. Even the maker of a motion is entitled to ultimately vote against it, and he does not stultify himself by so doing. On the contrary, his adverse vote testifies to his courage, to his open-mindedness and the soundness of the contrary views of his fellow directors. Beyond that, it may often be important to submit a motion for the express purpose of having it considered and defeated. Frequently, as noted previously, there

are occasions when the management or the board wants to make a record of consideration of a proposal it may intend to defeat. This is evidence, which may prove important later, that the board did not fail in its perception, even though the proposal was turned down.

For example, every board should periodically review company policies. It should consider and reconsider old and new factors in the light of changing conditions. A director who wants such a review may move to cancel an existing contract for the purpose of having up-to-date information supplied to the board concerning it, so that there may be full exchange of views thereon. Once those views have been expressed, it is most likely that the board as a whole will decide that the time is not ripe for change and unanimously defeat the motion. Or the motion may be withdrawn, with the consent of the seconder.

§ 132. Conduct of Meeting.

§ 133. —— By Presiding Officer.

The conduct of board meetings and the responsibility for their efficient functioning rests largely in the hands of the presiding officer, be he the chairman of the board or the president. An efficient and conciliatory presiding officer will do much for smooth and effective meetings; an aggressive or impatient one will breed and promote disharmony and ineffectualness.

An able presiding officer will so handle himself and his directors as to expedite decisions by encouraging, while controlling, without shutting off fair and needed discussion; he will promote conciliation, compromise and achieve ultimate unanimity of decision.

§ 134. —— Directors—Generally.

Organization of a new board of directors is akin to a marriage; once the honeymoon is over, the participants have to learn to work and live together.

In discussing qualifications of directors previously, we discussed the manner in which competent directors can and do conduct themselves at meetings; we suggested that they be legitimately inquisitive without being incredulous; that they manifest confidence in management without being blind to obvious fault; that they be cooperative but not spineless, courteous but not deferential, open-minded but not indecisive, firm but not obstinate and courageous without being aggressive. In short, we suggested that the competent director is the intelligent civilized man who is prepared to discuss, deliberate and compromise, and who wins and loses with equal good sportsmanship. Here, we seek to discuss conduct rather than qualifications, though the one flows directly from the other.

§ 135. Management Recommendations.

The director's task is immeasurably lightened when he knows that, given confidence in management in the field of operations, management's recommendations should be almost blindly approved. When, for example, management wants to extend or contract operations and make physical changes to permit so doing, the choice should be deemed that of the executives. This does not mean that it is not for the directors to make inquiry concerning costs and the prospective profits or losses of the operation, and to give their views concerning the prospective results. Nor does it mean that it is not the function of the directors to determine whether they are

prepared to sanction the necessary expenditures. But on the question of judgment respecting advantage to operations of the suggested changes, management's views should be accepted without question; if they cannot be so regarded, if the directors must even consider superseding management's judgment in a field where management should reign supreme, then the time is approaching when the board must consider the matter of replacing executives. But until then, and while the board feels it has a competent operating management, the latter's dicta should control in the fields in which management is to be considered expert, in the area of the job it has been hired to perform.

Here, the situation is like that found in the field of the law. When a federal administration agency, like the SEC, the ICC, the FPC, decides a technical question in its particular field, for example, whether a utility company is using a proper depreciation policy, and an appeal is taken to the courts, the judges say: We are not going to review the finding of the Commission concerning those matters in which they are the experts; we only are supposed to know the law; if you can show us some legal error, we'll do something about it; but on the technical matters, the Commission knows more than we do; so what they say goes with us.

So, with the board and operating management. Later, we discuss in detail their respective functions. Here, it suffices to point out that each should be considered supreme in its own field, although unlike the legal analogy above, both are cooperators in the first instance in a joint venture, so that, regardless of whose province is being inhabited, joint discussion and deliberation is the order of the day. But, in the final analysis,

the task of both is lightened when each knows whose is to be the final decision. And in the field of operations, it should be that of management—competent management.

Thus the board should sit in an advisory capacity rather than in judgment and, in the absence of fault or grave reason, the management's recommendations should prevail in the management's sphere.

It might be added that it is not infrequent for management to dilute, even to withdraw a recommendation after its proposal has had thrown upon it the light of discussion at a directors' meeting. It is not infrequent that, in the light of the information so adduced, a director might ask management: "Do you still feel strongly about this?" and get the answer: "No." This is the gem of open discussion.

§ 136. Dissent.

As we repeat so often, an undivided board is an effective weapon in the corporate arsenal and it operates most efficiently when charged with compromise. Nevertheless, there arise situations when a director, though in a minority, will feel the need for standing firm and go down in defeat rather than compromise; when he will feel that the issue justifies him in having his dissent recorded.

The dissent of an ordinarily compromising director, even the threat of a dissent, though ineffectual votewise, may become a powerful influence, provided it is intelligently and sparingly employed to induce compromise, even withdrawal, of a proposal. It is effective when the board is a harmonious board, when it is not torn by rifts or accustomed to dissension and division.

To be effective, the dissent must come from a director whose opinion is valued by the other members of the board. It is effective not only because the board has come to know that it gets the best results through harmony, but because, if a well-regarded director, given to compromise, feels strongly enough to dissent, his opinion must be given weight by the others, they must feel that he may be right and they, though the majority, wrong.

In passing, it might be noted that it is not unusual, in the practical working of a board, for one or two directors to strongly influence the board action in proportion beyond the justification of their voting strength; and this for the good and legitimate reason that intelligence and judgment, demonstrated over a period by board experience, will find recognition. Just as a good man in a conference soon finds his level, so a good or better man on a board finds recognition and ultimately exerts a proper influence beyond his voting strength.

§ 137. —— Example.

The Lackawanna Railroad applied to the ICC for permission to put two directors on the board of the New York, Chicago and St. Louis Railroad (Nickel Plate). Lackawanna claimed this right as the largest stockholder of Nickel Plate and pointed out that its directors would constitute a small minority of the Nickel Plate board and therefore would not infringe the statute prohibiting one road from controlling another. Nickel Plate objected, saying that though a minority, "strong directors sway the thinking of directors who are not so strong" and added that directors representing the

largest stockholder would exert an undue influence. An ICC examiner upheld the Nickel Plate contention.

§ 138. —— Obstinacy.

Of course, no weapon constitutes a threat when it is waved constantly. So, an obstinate and unyielding director not given to compromise, a director who dissents constantly, ultimately makes his dissent mean as little as his prior argument. A perennial dissenter finds no one receptive to or influenced by either his vote or his reasons for it.

§ 139. —— Necessary Dissent.

There are times when a director must dissent—and have his dissent recorded, and no compromise avails. These are situations where he or the corporation faces possible legal liability, for example, in cases of improper dividend declaration, approval of a misleading financial or registration statement, or approval of corporate action that may lead to stockholders' suits.

Here too, the threat of a recorded dissent from a responsible and intelligent director may effectively block the threatened action; a sufficient number of directors, lacking ulterior motives or recklessness, should hesitate to subject themselves to even the remote possibility of legal liability.

§ 140. —— Examples.

Of compromise induced by threat of dissent:

The president of a company had made an industry wage contract which, however, was not binding on the company until approved by the board. In the ensuing

discussion, it was evident that all but one director was prepared to approve. The latter, however, maintained that the contract was so improvident that it would wreck the company unless certain losing operations were discontinued. These operations members of the board had been pressing to close down for several years; however, the president had maintained that the union would not permit the company to lay off the men. The objecting director insisted upon the minutes recording his vote and his reasons therefor; the other board members sought to induce him to approve. Finally, a compromise was effected; in exchange for a unanimous vote, the president agreed to close down the losing operations in six months, regardless of the attitude of the union.

It might be noted, in passing, (1) that the wage contract played a large part in practically wrecking the industry; and (2) that the losing operations were discontinued without labor repercussions.

Of withdrawal induced by dissent:

An executive whose employment was being terminated desired to dispose of his stock. The president felt that in fairness, since the market would not absorb the large number of shares to be disposed of, effort should be made to place the stock. He offered to take half the block and unable to place the remainder elsewhere, proposed that the corporation acquire it. Though the corporation had legal power to take the stock, one director felt that the company's cash position did not warrant making the purchase. He proved to be the only dissenter when the vote was taken, but felt so strongly that he insisted on having his dissent recorded.

Thereafter, moved by the record, other directors put pressure on the president to place the stock elsewhere;

as a result the management proposed an employees' stock purchase plan which absorbed the stock and left the company with its cash position unimpaired.

An unusual and extreme situation was disclosed when the annual report of the Thermoid Company for 1954 was issued, signed only by two directors who had "had less connection with management than any of the other directors." The report disclosed that from 1951 to 1953 "accounts of the parent company and its subsidiaries were manipulated for the purpose of diverting profits from the parent company to the subsidiaries (or vice versa), thereby improperly reducing income and excess profits taxes . . . by the preparation of fictitious and incorrect documents."

Of futility of dissent by an obstinate director:

A director of an industrial company had such strong financial notions that other members of the board began to regard them as obsessions. In consequence, whenever a financing situation arose, the director advanced one of his pet notions, disregarding the fact that he had advanced it before and that the other members of the board had voted unanimously to the contrary. The result was that when some financing phase came up, no one listened while he talked, no one would second his motions, and automatically all waited for him to record his dissent. And the pity of it was that when he did come up with a good idea, no one paid any attention to it or him.

Of improper dissent:

At a meeting of the board of a large utility corporation at which a majority had approved the issuance and sale of securities, one director dissented. The issuance of the securities required the approval of the

Public Service Commission; ordinarily a mere formality. However, in this particular case, the dissenting director appeared before the Commission and asked it to disapprove of the issuance. No question of bad faith of the assenting directors was claimed; there could be no doubt that the question at issue was one that involved the exercise of the directors' judgment. Yet the intransigeant director sought to review the majority's judgment outside the board room; the unsuccessful result attested not only the impropriety but the recalcitrance of the objector.

§ 141. Unanimity.

We stress constantly that an effective board is a harmonious board, that competent men, who discuss freely, must constantly reach a point of agreement where dissenting views can be reconciled and merged in compromise, a compromise that spells moderation, that avoids extremes. As in music, harmony is agreement, not a single note but a blend of notes, not a single view but a blend of views. When a board achieves unanimity, it marks the end of factionalism, of selfish politics, of blind partisanship and prejudice. On such a board there will be no parochial differences, a single intelligent opinion will direct board conclusion, will be ample sponsorship for a rational proposal, will veto an irrational one. Ultimately, policies will be moulded from precedents and the need for argument will dissipate.

Of course, unanimity is the mark of an inactive board but that unanimity is born of torpidity, not of discussion and deliberation. The unanimity bred by the latter is the mark of an active, intelligent and competent board and most effectively serves the corporate purpose.

Nor does the fact that an open-minded man goes on the board as the result of stockholder disagreement serve to rend the possibility of harmony. Unless deep differences of policy are present, men of good will and of good faith can and will agree, regardless of what actuated them at the outset. Here, the statement of a lawyer is appropriate. "I never go to lunch with an opponent before a court trial," said the lawyer. "I find myself most effective in a trial when I think my opponent a so-and-so acting in bad faith. Sitting over the luncheon table with most men destroys that illusion and makes me less effective in the courtroom."

§ 142. Notes and Memoranda.

When an agenda is not complete, or when inquiry and discussion discloses facts bearing on a question before the board that are not mentioned in the written data before the directors, if the matter is an important one, as previously noted, a director is well advised to make additional notes on the agenda bearing on the added facts which influence his decision. These are frequently of future help in recalling the bases for decision and supplement the minutes of the meeting.

The practice of taking notes, like most, can be carried to a noxious extreme. For example, on a divided board where the feeling ran high, a director, an expert shorthand writer, took verbatim notes of what each director said. Knowing they were being taken down, the other directors became cautious, indeed so cautious that some became fearful of saying anything on a controversial or touchy subject. Ultimately, better relations were created, the note-taking was discontinued, and the board

members found they could speak more readily at meetings.

§ 143. Outside Aid.

Where board members lack complete confidence in management's ability to study and report on technical problems, or where management makes technical contentions respecting board members' suggestions concerning which the directors lack technical reply, board members may need to avail themselves of outside aid to assist in meeting discussions. Frequently, a director's own accountant or lawyer can make an independent investigation and arm the director with the needed data; on occasions, the task is a larger one that calls for corporate retention of some outside agency, such as business consultants, engineers, bankers, and the like.

For example, in formulating dividend policy, it is usual to find operating management desirous of conserving cash resources and consequently be overconservative in dividend policy recommendations. Directors who advocate a more liberal policy must frequently go to their own brokerage sources for statistical data for use in meeting discussion in order to demonstrate, for example, the prevailing dividend rate in that particular industry.

A director who thus arms himself with data supplied by outside sources makes himself effective, not only with his less diligent fellows but with management, which is thereby induced to make full and fair presentation respecting issues to come before the board, knowing that if it does not do so, the diligent director will. A director who thus supplements management's factual data is performing a service which is a director's main duty

respecting operating problems, he is helping to make management fully conscious of what the problem involves and as well supplying leads to the answers; more than this no director can do respecting matters within management's province. We have adverted to this previously, in connection with directors' qualifications.

§ 144. What Not to Do.

As we point out, the purpose of meetings is to get the views of management and the board members, thrash them out and ultimately resolve them into a cohesive conclusion. Consequently, any attitude or action that impedes the facets of this purpose should be a "don't-do."

While out-of-meeting contacts between management and individual directors, and between individual directors, can, on occasion, serve a useful purpose, they are more likely to be the subject of abuse than of use. In the first category are advance discussions between management and influential directors designed to enable management to make up its mind, or to test its theories. Every man needs advice and is entitled to get it from sources he respects. But when the meeting is for the purpose of "lining up" directors, so that the result at a meeting will be a foregone conclusion, obviously the purpose of such out-of-meeting contacts is to subvert discussion, not to aid it.

So, too, when a director has some criticism of management. In such case, a private meeting and discussion may clear the air, get the facts straight, end what may have been a misunderstanding and avoid a rift at a board meeting when the presence of others might prevent a frank disclosure, or a half apology that might

heal an injured feeling. So here, such a by-pass of board discussion may be helpful and justified. On the contrary, secret meetings to form a secret cabal to promote dissension are at variance with the concept of a free, full and fair airing of issues.

The difference between the good and the bad, obviously, is a fine one; the underlying motive and intent turns down one road rather than the other. Manifestly, what the director is not to do is to promote individualism; the board should be informed as a whole so it can act as a whole. Whatever retards this process, should be avoided.

§ 145. —— Examples.

A director advised the president that he had matters to discuss with him concerning operations and policies and asked that he be available for lunch preceding a two o'clock board meeting. The president was unable to be available before the meeting and so informed the director, who suggested a conference following the meeting. The president, unwilling to be drawn into a private discussion, cut short the agenda for the meeting so that time would be available for the director's discussion at the meeting and asked generally whether any of the directors had anything to discuss. The director in question remained silent. Other directors who had been apprised of the situation were naturally resentful, feeling that the director's secretive attitude reflected upon them.

CHAPTER X

Powers and Functions—Delegation, Allocation and Exercise

§ 146. Duties of Directors.

§ 147. —— Generally.

By accepting the post, a director assumes duties which may be summarized as (1) statutory duties; (2) the duty of caring for the stockholders' property; (3) the duty of managing it, and (4) the duty of representing the stockholders in and about the corporate affairs. Correspondingly, the directors are vested with

such powers ("abilities to act") to function ("perform such acts") as are necessary to fulfill these duties.

§ 148. Delegation of Powers and Functions.

The corporate bylaws provide for delegation of directors' powers and functions to officers appointed by them, and the bylaws specify the basic duties to be performed by such officers under the supervision and control of the board.

It is to be noted that though the board delegates functions, it does not surrender its powers respecting them. Consequently, its delegation of power is always subject to revocation, at its will and without cause.

§ 149. —— Powers and Functions Not Delegable.

§ 149a. Statutory and Charter Provisions.

The directors are expressly charged, either by statute or by the corporate charter or bylaws, with specific duties; for example, of electing or appointing the principal executive officers of the corporation and of fixing their salaries; alone, or in conjunction with the stockholders, of authorizing changes in the capitalization of the corporation; of issuing and retiring stock; of mortgaging, selling or leasing the corporate assets; of acquiring new assets; of determining whether the corporate business should be continued or merged or consolidated with another, whether the corporation should liquidate its affairs and dissolve or whether it should take resort to bankruptcy proceedings or seek reorganization.

These generalities are supplemented in particular enterprises by the corporate laws, state or federal. In

the case of special corporations, life insurance companies, banks and trust companies, utilities, and other particular enterprises, directors may be, and usually are, charged with special duties, or the manner of the performance of their duties is especially prescribed or limited.

These primary and fundamental duties are charged to the directors by the law and the corporate charter and constitute nondelegable functions to be performed by them.

§ 149b. Care and Control of the Corporate Assets.

The duty of caring for and controlling the corporate assets in many instances charges a director with obligations of a fiduciary and these a director cannot avoid by delegation. Thus it is the director's duty to see that the corporate funds are banked in a respectable institution and that its surplus funds are safely and not improvidently invested.

However, the use of corporate funds is so inextricably woven with the management and current operation of the affairs of the corporation, that the subsequent use and employment of the corporate funds falls not into the care and custody but into the management functions of the board. According to the dictionary: "to manage" is "to conduct or to direct the affairs of" and "to direct" is "to instruct or guide." Since the duty of directors "to manage" is not a fiduciary duty, the law grants a board of directors power to itself conduct the affairs of the corporation or to direct their operation by others. Thus it is properly said that powers to manage are ones that directors may delegate to others.

Consequently, this division of the director's duty, in-

volving the care and custody of the corporate assets, may be said to involve mixed nondelegable and delegable functions.

Since in all but the nominal corporations engaged in small private businesses the board appoints officers and delegates to them its powers and authority to operate the business of the corporation, and since, as a practical matter, as will appear in the following chapter, the operating executives run the affairs of the average corporation, this matter of delegable or nondelegable authority becomes largely academic. It does become important, however, when controversy arises or catastrophe occurs and liability is sought to be charged to directors.

Since the corporate concept not only permits but contemplates the delegation of managerial powers, it must be obvious that the law is bound to be more lenient in its view of untoward consequences of such delegation than it is when unfortunate results occur by reason of the delegation of directors' trust duties.

Consequently, to avoid conflict or risk, it is well for executives and directors to be aware of the respective areas of functions and their exercise. Such knowledge and adherence, too, make for smoother cooperative functioning between executives and directors.

§ 149c. Stockholder Representation.

Into this same category of mixed functions falls the duty of directors to represent stockholders. Here again, since directors are elected by the stockholders as and to be their representatives and since the law classes the directors as fiduciaries for the stockholders (as appears in some detail in our later discussion of directors' liabilities), one must conclude that basically the duty of

affording stockholders such representation is a nondelegable function. However, as will appear in our later discussion of the subject of stockholder good will, the care and treatment of stockholders can best be left to the delegated powers of the officers, except where conflict arises between stockholders and the incumbent executives; and here, as a practical matter, directors usually join with executives to become incumbent management opposed to the stockholders they have been elected to represent.

§ 149d. May but Should Not Be Delegated.

§ 149d1. Exercise of Discretion.

In the category of functions that directors may, but should not, delegate may be included those that necessarily call for an exercise of the directors' discretion.

The law is not entirely harmonious on the question of whether directors may safely delegate powers involving the exercise of their discretion. But it is uniform in charging the director for total failure to perform a duty charged to him.

So when we find a director entrusted with a duty to exercise his discretion and he attempts to perform the duty by shifting the problem to an executive, the law may well charge him with a violation of his duty for a failure to exercise his discretion.

For example, assume a company is operating one of its plants at a loss. The directors consider whether or not it is good business policy to continue its operation or to shut it down. They decide to continue, and the company suffers large losses as a result. The directors have no personal liability, since they have used their best judgment.

However, assume the directors have delegated responsibility for the operation of the plant to a local manager and they leave it to him to decide whether or not to continue operation. He decides to continue and the company suffers resultant loss. Now the directors may be personally liable because they failed to bring their own judgment to bear upon the problem.

Again, assume the board of a shipping company totally disregards the question of whether cargoes and ships should be insured against fire or catastrophe and leaves the matter to management, without any attempt to determine what has been or is being done. Assume management embarks upon an improvident policy of self-insurance in order to swell profits and increase its profit-sharing bonuses. A heavy loss might well make the directors chargeable to the corporation, while, if they themselves had considered the question and determined it honestly as a matter of policy, their bad judgment would have subjected them to no consequence.

In short, if the exercise of a power, though delegable, involves the exercise of a discretion, the directors may delegate, but perhaps at their peril, since such delegated functions may include duties which a director should not delegate.

§ 150. —— Delegable Powers.

When we leave the realm of the trust duties of the directors and the powers and functions arising therefrom, we enter the field of the managerial powers of the board. Here, at the other extreme from the trust area, we find powers and functions that the law contemplates will be delegated to the executives—the operating management. Again, it is to be noted that there are no in-

herent powers vested in the executives. All of their powers, including the powers to operate and conduct the current business of the enterprise, are delegated managerial functions.

In the case of the trust relationship, the basic premise is that all duties must be performed by the board and may not be delegated, with the burden on those who seek to create exceptions; conversely, in the case of managerial powers and functions, the basic premise is that all powers and functions may be delegated, with exception rare and to be demonstrated.

§ 151. —— Retained Board Functions though Power Delegated.

Though a function be properly delegated to operating management, the board's responsibility is not ended thereby. The underlying duty of management carries with it the burden of supervision and review. The legal responsibility of the board encompasses, in the case of delegated functions, the continued responsibility to keep informed respecting the manner of their exercise and the results achieved thereby. Here, when occasion demands, the board must review the manner of exercise and the results and, where needed, direct change in the *modus operandi.* This we treat as the duty of review.

§ 152. Allocation of Functions.

§ 153. —— Guides.

Later, we discuss the practicalities of allocation of functions between the board and the operating management. Here we discuss the bases which, academically at least, should govern that relationship.

At the outset it must be remembered, as pointed out elsewhere, that the board may exercise a function solely by making a decision.

§ 153a. Long-Range Policies.

The underlying corporate purpose is, of course, to create an enterprise that will outlast its organizers, stockholders, directors, officers and employees, one that will surmount changing political, economic and social conditions to earn profit for its stockholders. Consequently, the basic task of management is to so maintain the corporation and so conduct the business that both will live and prosper, now and in the future.

This twofold purpose immediately suggests practical modes of execution; first, the reservation in the board of functions attendant upon long-range continuation of the enterprise, and second, the delegation to the operating staff of the current routine and ordinary day-to-day corporate business.

For a long-range corporate program, the board must determine the state of the corporate finances, what is needed for working capital, what is available for expansion, and such other factors as may be involved in maintaining and expanding the business successfully. The board must determine how much it can expect to reserve from current and future earnings for such purposes. This, in turn, will require the formulation of a dividend policy.

Consequently, the board must pass upon financial estimates and budgets so it may know what the corporation can afford to provide from its own resources and determine how, by stock increases, by incurring debt or otherwise, the remaining cash needs can be supplied.

The board must see that the corporate funds are used intelligently. It must know that there is a time for spending—that money is made by risking the loss of money—that there is also a time to retrench, to husband, to hoard one's resources. It must determine when and under what conditions the corporation requires and can afford a profit-sharing or stock bonus or stock option system.

In this long-range connection, the board must have in mind the obsolescence that the ravages of time produce, not only in the physical structure of the things that comprise an operating plant, but in the manpower that constitutes an operating organization. As the board is directly charged with the nonshifting duty of appointing a chief executive, it must have before it the ever present consideration of the selection of his successor. For that purpose, it should know, at all times, what other manpower materials are available to replace decaying foundation timbers in the operating organization. While employees relations are for the management, provisions for retirement and pensions are long-range matters for the board.

A long-range program necessarily involves also the need of constantly adapting the corporate structure to periodic withering storms of change. This involves constant shifting of means and methods in production and sales, of appliances, of styles, customs and habits, in consequence of advancing technological and management techniques, or of political, social and economic innovations. It involves questions of expansion and contraction of the business, attention to the budget of proposed annual capital expenditures. These are the inevitable concomitants of any business and industry,

and call for adaptation and anticipation, born of perspective and vision.

The long-range duties of directors, and their attendant functions, must necessarily carry the board into a multiplicity of the various current phases of the corporate life.

Here again, we may repeat that it is not necessary, indeed, it would be futile, for the board itself to attempt to do all the things needed for the adoption of a long-range program. It must depend primarily upon executive management but should call to its aid, as required, bankers, management experts, economists and other technicians. It is only because such assistance is available that a board, however actively disposed, can perform its necessary functions without devoting full time to them.

And it is not only fitting, but practically advisable, that the board should concern itself with these long-range functions. It is the board members to whom the enterprise should look for vision and perspective, a long-range point of view consequent upon greater outside experience and contacts. The fact that the board members are disassociated from everyday problems of the business enables them to bring to bear upon its larger and ultimate problems a broader vision and greater perspective than may be expected of operating management. The outside interests of the directors, their daily experiences in other professional and industrial fields, all contribute to an ability to make the more comprehensive and lasting judgments which the achievement of ultimate objectives requires.

Today's corporate problems, as indeed today's indi-

vidual problems, center about norms of political and economic interplay of nations and their national resources, of changing scientific, economic and social concepts, with their immediate and remote economic consequences. What is the market going to do gives way, today, to what is Russia going to do, or France, or England, to problems of inflation and deflation, of money rates, of tariffs, of commodity shortages or surpluses. Even a well-balanced and experienced board cannot supply all the answers. But a full, free and intelligent discussion can point the way to policies of chance taking when taking risks is indicated or of conservation of limited corporate resources, when doubtful portents appear.

And here, too, circumstances necessarily alter cases. Manifestly, what has been said has full application to some industrial corporations, while others are but slighty affected. Conversely, these principles have little, if any, application to the ordinary bank. Generally, the long- and short-range program of the average commercial bank has been thought concurrent: to keep its depositors and to get new ones; to make safe loans and safe investments. But even in the case of the banks, ambitious short- and long-range programs are feasible, expansion of types of service is called for, as witness the new look prevalent throughout banking circles today.

It is interesting and informative to note the coincidence of result in the application of the different standards herein suggested. When the test of long-range planning is applied, it will be found that the test of care, custody and control of assets dictates the same conclusion of board jurisdiction, as immediately hereafter it will be shown, that the standard of basic policies affect-

ing managerial functions also reaches into the care-custody board province.

§ 153b. Basic Policies Affecting Managerial Functions.

Though, as stated, managerial functions are delegated to and are within the keeping of the executives, the reservation to the board of long-range policy decisions points the way to similar reservations concerning the broad basic policies that underlie current operations. Here, again, broad questions of finance are found involved when, for example, addition to or change of production facilities is proposed by management, when a change or an enlargement of products is contemplated, when questions of blanket salary or wage increases, bonuses, rates of commission, change of methods of payment of subordinate executives or employees is involved. Similarly, questions of research, advertising, public relations, invariably involve budgetary matters, as do the installation of cost systems, labor-saving devices, and a host of other similar matters that primarily involve current management and operations.

The board's duty of review, discussed hereafter, likewise brings within its range major matters primarily operational.

In connection with policy making, it must be borne in mind that policy making often is not the result of formal conscious action, but is frequently evolved as a result of a particular action in an individual case, or a series of individual acts, without realization of the ultimate policy effect. Such acts, though operational, may bring board jurisdiction into play.

For example, if a controversy respecting an employee, under existing labor conditions, may precipitate

an authorized or a "wildcat" strike with damaging consequences to the corporate treasury, the question, however trifling or routine it might otherwise be considered, may require submission to the board. The determination of a wage, closed-shop or other labor negotiation, with a threatened strike, a determination by executives to resist a governmental decree, contemplated acts which may result in legal proceedings, these and others of like import may rise into the category of policies within the inherent jurisdiction of the board.

For example, an old employee wishes to retire; a mellow board votes him a monthly life-long allowance without conditions as to whether or not he intends to supplement it by taking another job. When the word gets around, a number of aged, but still effective employees, offer their resignations, expecting the same treatment and the board finds itself in the midst of willy-nilly consideration of a pension plan.

So, too, a method is adopted of seeking the tender of bonds for retirement; the method suffices under existing circumstances; years and many tenders later the board finds that, without full consideration of many factors which now pose problems, it has drifted into a fixed policy.

Again, the president writes letters to stockholders without consultation with the board. Years later, upon an occasion when the board finds itself in disagreement with the views which the president intends communicating to the stockholders, it finds that it has tacitly and unwittingly approved a policy that denies it its rightful place as a screen to protect the interests of the stockholders it should represent.

§ 153c. Managerial Functions.

It seems needless repetition to point out that matters that center about the daily and current operations of the business and its administration, are functions to be exercised by the full-time employees and executives of the company, the operating management. Here the board's function may, from time to time, be advisory, when management seeks advice or needs it; otherwise the board function is confined to one of review, as heretofore noted and later discussed.

Subject to the board's functions concerning long-range and basic policies, as previously stated, it is for the executives to set up and assemble its plants, to operate them, to determine labor policies, the details of production, to set up sales programs and fix prices, establish selling and administrative organizations, fix salaries of employees, hire and fire them, arrange for advertising, supervise relations with suppliers and consumers; in short, to do and supervise, determine and revise the endless detail of production, sales and administration, the components of profit and the source of dividends.

This is the province of operating management. It is what it is hired for. Managerial powers to do these things are delegated to the executives by the stockholders and the directors. But when they delegate these powers, they have a right to expect that they will be exercised under the reserved managerial powers of the board to supervise, review, and where needed, revise.

§ 154. Exercise of Functions.

It may be noted that directors' powers are exercised by resolutions adopted at board meetings; that one

board may not act to control or otherwise limit or foreclose the powers and functions of a subsequent board, except as the bylaws or charter specifically permit; that a director may not legally bind himself to act or not to act in his directorial capacity in a particular way at a future time.

§ 155. —— Decision.

The elements of the exercise of a function ordinarily are three: (1) the formulation of a plan; (2) the decision to execute it; and (3) its execution. The essential element in the exercise of a function is the decision.

When a function is to be exercised by the board, the essential requirement is that the decision be made by the board. The board may come to a decision though the elements of that decision, the advance preparation, the formulation of a plan as well as its subsequent execution, may properly come from or rest with management.

All that may be required, when a function is to be exercised by the board, is that it should be fully informed concerning the problem and come to a decision by the exercise of its independent and informed judgment. It may—but need not—personally exercise all the elements of the function. The decision itself may and usually does also represent the prior conclusion of management; it suffices if, after due consideration, it is adopted by the board; it is thereby none the less the decision of the board.

§ 156. —— Ratification.

From time to time, management will submit to the board formal matters calling for formal approval and

an active board will acquiesce. On occasion, management will take the board's approval for granted, and proceed to execution without awaiting the board's action. But when a board finds itself constantly requested to "ratify" acts of the executives, the sign is clear that management seeks a lax rather than an active board.

The practice of ratifying decisions previously made by operating management concerning matters within the boundaries of board jurisdiction finds a valid but exceptional place in the corporate scheme. When such decisions are required during the intervals between meetings of the board and there is no executive committee and the questions involved are not unduly controversial or important, operating management may be expected to make the necessary decision, take the necessary action and submit it at the next meeting for the board's confirmation.

However, this practice can develop into a bad habit and get out of bounds. When it does, it should not go unchecked.

In addition, there is always the danger that the board may reject and refuse to ratify the act of an officer. In such case, complications and lawsuits may ensue; a third person outside the corporation may claim he was legally justified in accepting the officer's authority and may hold the corporation to the resulting contract and recover damages.

"Ratification" should be distinguished from the practice of seeking confirmation by the board of acts that either lie within the scope of the executives, or belong somewhere along the boundaries between operating management and board jurisdiction. Such confirma-

tion is, in substance, an extension of the counsel and advice function of the board. Instead of coming to the board first for counsel, cooperative operating management may act first and then seek the board's opinion; for example, this may properly be done concerning changes in operating personnel that executives prefer to observe in action before discussion with the board.

§ 157. —— **Execution.**

Once the board, with the full aid and cooperation, and indeed, at the instance of operating management, has thrown its independent and informed judgment into the mould in which policy decisions are formed, their translation into action is in the exclusive province of the executives. At this point, operating personnel entitled to confidence is to be given its head, let alone, encouraged to exercise its initiative and energy and get results.

Once the time for deliberation has passed, the board must remember that what it seeks is dynamic personal action by members of the operating staff and, aware that argument will dull the edge of action, it must accord the executives freedom to exercise their initiative and energy in action. This also is a measure of the directors' contribution to a coordinated enterprise, to mind their own part of the business and let operating management attend to its part, giving freely only when and as the executives seek the board's affirmative participation.

In this respect, the corporate setup again is akin to our political constitutional policy that calls for policy making by Congress and execution of such policies by the executive branch, with ultimate review by Con-

gress. In the execution of policies—be it political administration or corporate operations—the rule-making body can and should observe without participating. And it can and should oversee without interfering.

§ 157a. Interference.

Interference with management's exercise of functions generally occurs in one of two fashions, one, by board interference in what are essentially operating matters, and two, by the acts of an ubiquitous or overdiligent director.

Board insistance upon participation in operating problems and their solution is largely due to a lack of knowledge of what functions are the board's and what management's. It might be remarked that it is also common for management to submit to the board what are essentially management operating matters, not because management seeks advice but in the same mistaken belief that these are functions of a board.

The overdiligent director is not a *rara avis.* His interest in the corporate affairs is so considerable that he insists on visiting the president and other officers during intervals between board meetings and invites them to lunch for the purpose of talking things over. He may also undertake to visit the company's offices and plants in his spare time, talk with subordinate officers and employees, make private investigations of company methods and practices, and generally concern himself with management's execution of its functions. We have described him heretofore.

Manifestly, such a course of conduct is harmful and finds no justification, even though such a director may be actuated by the best of motives and may seek to

justify his actions by an effort to learn facts that will aid him in performing his directorial duties. Such activities are bound to embroil him and others in intercompany politics, to make superior officers suspicious and to undermine their authority with subordinates. Here, again, the corporate scheme furnishes the answer; the board functions jointly; its powers and authority are to be exercised jointly. Consequently, a director who seeks information should seek it through official channels, and when disclosed, it should be made available to all members of the board so that the board may jointly function on the basis of common information tending toward a common judgment.

Similarly, if plants or offices are to be inspected, that should be done on given occasions, by arrangement by management with and for the board.

The point here made is twofold, one that execution of a board function should be by the board and not by individual members, and two, that the board should not interfere, individually or otherwise, in management's execution of its functions.

§ 158. —— Review.

§ 158a. Generally.

We have made the point heretofore that though the board delegates functions, it retains the duty of periodic check and review. This requires the directors to keep themselves informed, particularly informed of what their company is doing and generally informed of what other companies in the industry are doing.

§ 158b. Current Operations.

Needless to say, every director should receive a monthly operating statement, report of sales, and profit and loss statement, a periodic balance sheet, cash flow statement, annual operating and capital expenditure budgets, and other reports that are needed to keep abreast of the flow of the tides in that particular business. Every director should familiarize himself with the particular rules of thumb that indicates the course of that particular business; are sales up in relation to inventory or is unsold stock piling up? Is annual turnover up to industry standards? Are sales moving ahead of last year's? Are administrative costs mounting and exceeding a proper percentage of gross income? Etc. Etc. In this fashion, directors keep abreast of and review current operations, the execution by management of its delegated functions, so that the board may check before the corporation is hurt.

§ 158c. Administration.

Connected with current operations are matters of administrative detail. From time to time, these justify directors' check and review. Simple inquiry about what is being done, and, where necessary, short discussion about what ought to be done will satisfy this duty, and where needed, awaken management's consciousness. So, for example, a director may inquire: How are purchases made? Competitively? Do a few favored concerns get most of the business? What check is made to insure fair prices? Is office equipment being kept up to date? Or is obsolete equipment and method still in use? Is billing, filing, done with modern tempo? Or

are slow, old-fashioned and unnecessarily expensive methods still being employed?

Without being offensive or interfering, from time to time directors should make reasonable inquiry concerning one thing or another bearing on administration, as occasion suggests. It is to be remembered that board members get around, they hear of new techniques which may serve management's consciousness and purposes. Management awareness can be aided by director initiative.

A board should check and review, from time to time, the internal techniques which may bear on the ultimate financial results respecting which the board is the final keeper. The owner of a business, though he entrusts its operations to others in whom he has confidence, does no less if he is diligent in the protection of his own interests. And that is the measure of the director's duty. It is not enough for him to await the accidental denouement to learn that a frail purchasing agent has taken "kickbacks", or to insist upon the adoption of methods and techniques designed to prevent such a consequence. Though such precautions are the primary business of management, inquiry to ascertain the existence of such safeguards is the correlative business of the director.

§ 158d. Other Matters.

Current operations, of course, are only one of the many phases of the board's obligation to review. There is little of importance in the corporate life, short of detail, that does not call for the exercise of this function of the board. And necessarily, full review requires current and adequate information which, in turn,

hinges on the board's constant and active scrutiny, observation and consideration.

Inspection by directors of physical properties, of production facilities, of sales offices, research and advertising departments, of managerial offices—each of these equips the director for a better and more complete understanding and more expeditious and capable disposition of problems when they come before the board. It is the professional, not the business mind, that can more readily grasp the subtleties of abstractions. Business perceptions are better keyed to the use of the physical faculties and business judgment based on testimony of the senses is the more reliable.

Back in the late thirties, the corporate world was shocked by the revelations in the McKesson and Robbins case. It may be remembered that one Musica, an ex-convict, masqueraded for a number of years as a top-notch business executive, the head of the huge drug concern of McKesson and Robbins, and fooled not only his associates but a board of directors that included some of the leading legal and financial lights of the inner Wall Street circle. When the skein of fraud was ultimately unravelled, it was found that at its center were nonexistent inventories which the balance sheet represented were to be found in warehouses. Indeed, some of the warehouses themselves were imaginary. It was ultimately revealed that neither the directors nor the company accountants had ever made the physical inspections which readily would have revealed the absence of the foundations of the recurrent balance sheets which were submitted to the directors and which they had approved periodically.

Reports and statements of the corporation and its

departments and of other companies, trade periodicals, industry reports, governmental releases submitted by cooperative executives to the board aid it in its search for understanding and premise intelligent review.

The selection of auditors independent of management and the presentation by them to the board of reports designed to give a view of operations and the consequent effect on the financial status of the company are essential to the exercise of the board's reviewing function. This latter task is frequently delegated by the board to a standing audit committee, as we have pointed out previously.

A board may also find it advisable to obtain other outside aid to enable it to review operations or other matters affecting underlying policies, and for this purpose the services of independent banking, engineering and management experts are available.

§ 159. —— Advisory Functions.

In between the matters which the board itself decides and those which it reviews is a third class, those concerning which it merely counsels and advises. Rather than an exercise of a separate function, this is more a feature of the cooperative spirit that should link the two main corporate elements and naturally flows from mutual respect that, in turn, is bound to grow from mutual competency. Such cooperation is fostered by a mutual frankness which, in turn, rests upon a mutual lack of suspicion of ulterior motives and purposes.

Such practice of cooperation is a mark of tribute both to operating management and the board. It demonstrates that operating management is open-minded and

not egocentric, that it is alive to the value of its board and that it considers the board competent.

This is true, of course, provided only that the matter in question is not one that a board should itself be passing upon; then it would only be evidence that operating management is contracting essential board functions to mere tokens by translating the element of board decision into mere counsel.

If an operating management genuinely seeks board suggestion and advice, it will necessarily be sought in connection with matters wholly within the orbit of operating management. Of course, it is far more natural for operating management to be able to advise the board in connection with its functions than for the board to be able to advise operating management respecting current operating problems. Consequently, in practice, the latter is more infrequent than the former. But the frequency of the board's attempt to help will depend on operating management, whether it invites and welcomes suggestions, or becomes resentful and defensive when aid is proffered.

CHAPTER XI

Powers and Functions—Practicalities of Allocation

§ 160. Allocation of Functions.

§ 161. —— Will Be Effected Empirically.

Regardless of what students of the law or of corporate practices may say should be the allocation of functions between the board and the executives, the share of each management element in the common effort will ultimately be determined, after experiment, by the common practical method of trial and error. Like a team, the corporate members of management will develop teamwork through actual operation, and thereby develop the cohesion that will fit the respective grêater and lesser abilities and energies of the individual members into a smoothly working unit.

Again we repeat—we are here dealing with the public corporation of average size, the larger rather than the small corporation. Manifestly, the smaller the corporation, the more blurred the distinction between ownership, board and operational personnel, the more determination of policy and execution of operations tend to coincide and the less the delegation of powers.

When in the larger corporation management includes persons competent to pass upon particular issues, or when management calls to its aid outside sources for that purpose, it is in a position to do everything but render the ultimate approval, not only respecting operations, matters of managerial classification, but also matters strictly within board jurisdiction. A competent financial vice-president will formulate plans and policies respecting capitalization, issuance of equity and debt securities and present them to the board with his recommendation thereon; ordinarily the board will adopt the suggestions and make them its decision. Thus competence and authority blend into effective action; the legal proprieties and the business necessities are satisfied.

As a practical matter, where management is competent and the board active, the active management of the corporate affairs is nevertheless left to the executives; they determine its direction, subject to informing the board of the whys and wherefores. This is true not only respecting operating matters but also concerning the matters within the scope of the exclusive care, control and custody of the assets jurisdiction of the directors.

Ordinarily, the president initiates policy, operating and otherwise. If he does his job intelligently, after consultation with members of the operating staff and

members of the board, his formulation will represent a considered and all embracing judgment and will meet with board approval.

As a practical matter, given a competent operating management that enjoys the confidence of an active board, the latter fulfills its legal obligations in practical fashion by having brought before it proposals and policies formulated by management, and with sufficient information before it, approving. On occasions, an active board, by inquiry and deliberation, will suggest modification and open-minded management will concur. On rare occasions, an active and inquiring board will reject or suggest a substitute for the management proposal or policy.

Thus the legal and the practical requirements are properly met and, obviously, can most readily be met.

§ 162. —— Management Functions.

In the field of operations, the executives and their subordinates are hired as experts and may be expected to function as such; else they must be replaced. Consequently, here, the board's functions are invariably secondary, legally and practically. Here, competent management leaves an active board undisturbed while it formulates and executes its own-conceived operating plans. In such cases, the board need do nothing but check results and when they are satisfactory, continue to do nothing. Thus the legal obligation of check and review is satisfied, until results indicate that board action is required.

§ 163. —— Inactive Board.

As has been pointed out, the corporate scene is

marked by the presence of a good many practical operating men—their number diminishing—who contend that the needs of practical corporate operation require that the board be effaced in all but the exercise of its formal statutory functions. This school of thought finds ready illustration in the notoriously highpowered executive who described board meetings as "the slow way to meet problems that require quick action." The extremists of this management-in-the-saddle school are not inclined to respect even the board's right to exercise its legally reserved powers.

Where this type of management is found, an inactive board is its accompaniment, since ordinarily it is management that selects the kind of board it wants. We have discussed this subject at some length previously.

There is little apparent difference between the way such a board operates and the way an active board operates, when management is efficient. In both cases, as pointed out, management formulates and executes; in the case of the active board, management may and frequently does suggest the decision and the board adopts it. In the case of the inactive board, management frequently does not communicate its decision to the board unless it is in a field where the law requires formal board action. When management does inform the inactive board of its plans and decisions, the latter adopts them unhesitatingly, and never gainsays them; the active board approves on the basis of adequate information and an informed judgment, the inactive board on none at all.

The management that seeks an inactive board ordinarily has little difficulty in securing one. Even

when management has not deliberately selected directors for their potential of inactivity and disinterest, it is a simple matter to permit a board to become inactive. *In truth, management that wants an active board must make an effort to get one, not only by selecting men who can and will give the job the necessary attention* but by creating stimuli to keep them active and interested. This too has met with previous discussion.

§ 164. —— Allocation to Management Justifiable.

In the absence of some compelling motive, every incentive works to cause a board to leave matters to the executives. The latter have the incentives to excite their interest and activity; the ordinary director lacks them. A president is paid a substantial salary; a director receives a nominal attendance fee. The executives devote all their work time to the business of the corporation and if they are competent, devote much of their spare time to thinking about its affairs. The director usually has a business of his own, he devotes one day or part of a day at a meeting, and if he is conscientious he also gives such additional spare time as the corporate problems demand.

On the basis of this spare statement of undeniable fundamentals, how can one expect directors to "manage" the corporations' affairs? The fact is that they delegate the management to the executives and when they stand by to advise, counsel, supervise and check, in the absence of crisis, they feel they have performed their full measure of duty. Any other assumption is unrealistic.

§ 165. —— **Practices Vary.**

Obviously, no general rule of the practical allocation of functions between board and executive can be formulated. Practice must necessarily vary in given enterprises, under differing conditions, as they must vary between one enterprise and another, even under similar conditions. No common rule will suffice for every situation. The modest corporate venture and the limitless industrial empire find little common ground. The corporation with a strong and competent executive and a weak board and the company with mediocre operating management and an active board cannot prosper with common treatment. A company showing profit may need different treatment than when it is operating in the red. When stockholders control the board, one rule may suffice; if operating management is in exclusive control, another rule may be needed. When an enterprise operates under stable conditions, a board may relax; if the industry outlook is uncertain and difficult, vigilance and action may be called for.

There are occasions on which the most competent and active board will sit back and give energetic operating management its head. There are other times when the very same board must take over the reins. The basic practical purpose of a corporate enterprise is not to make obeisance to formal legal rules, but to produce profit. And within reasonable limits, that is what the conscientious director and officer will seek to accomplish as practically and expeditiously as possible.

§ 166. —— **Basic Requirement—Cooperation.**

What is needed, in each case, is the degree of con-

tribution from board and operating management that will produce the best possible blend of cooperation. Each situation must find its solution; like the Lincoln statement that a man's legs, whether long or short, should be just right: just long or short enough to reach from his body to the ground.

Since cooperation is a cardinal corporate virtue, coordination might be called a joint function of operating management and the board. A man's right hand normally carries on the major part of the day's operations, but one has only to lose the left to know how greatly it straightens out and eases its coadjutor's way.

So, when rifts appear in the organization, when labor cannot be handled, or the community becomes angry, the board can frequently suggest, advise or act in cooperation with the executives to settle the trouble. Frequently, with its greater prestige because of its remoteness—its lack of daily contact—it can do what operating personnel finds difficult or impossible. On occasion, it can assume the onus of decision and let operating management out from under. On occasion, the board can save operating management's pride, its face. On other occasions, the board can back up the executives and make them more effective. Together, a board and operating management can do much to iron out organization difficulties, inspire loyalties and build morale.

Indeed, an astute executive will and should come into the board for frequent counsel, advice or confirmation, and thereby have it share his responsibilities. Thus an intelligent executive will avoid the personal responsibility for failure.

While the president may and usually does consult

and advise with particular directors in whom he has confidence, his effort should be directed toward treating with board members as a whole; single board members should not be made the recipients of confidences not imparted to all. Of course, situations occur where it is not safe to make disclosure at a particular time to one or more incompatible or antagonistic board members, and it must be remembered that in corporations where cumulative voting prevails, or where there are stockholder rifts, boards sometimes comprise antagonistic elements. In such cases the corporate welfare may require a president to be politic at times, rather than frank. For example, it may not always be expedient to make disclosure to a stockbroker member of the board of impending events which may have an effect on the stock market, since such a director may find his corporate allegience clashing with his duty to his stock customers.

However, such situations should be exceptional; in general, a corporate president should undertake to deal frankly, fairly and advise equally with all his board members; and such treatment makes for a harmonious board and cooperative relations between the board and the operating management.

§ 166a. Example.

An example of the need for a cautious approach to disclosure was found in a situation where the president had come to the conclusion that it was necessary to shut down production and abandon certain local facilities. Though he was anxious to discuss the matter with the board, he felt it necessary to withhold disclosure until the last possible minute since members of the board were members of the community and premature disclosure

would result in labor and community pressures which would have retarded the contemplated operation.

§ 166b. In Exercise of Function.

A valuable contribution can be made to securing cooperation between board and executives if both appreciate what has been pointed out in the preceding chapter, that the board's right to make a decision does not exclude management participation, indeed, that the board's decision may represent management's initiative, idea, plan, recommendation and execution; that the board's sole role may be that of passing upon the validity of management's reasoning. With the possibility of the roles thus cast, there is no need or occasion for management to be jealous of the board's claim of right to be the final arbiter; management will know that it plays the stellar part. Nor has the board any ground for complaint; it can take credit for the active and competent management it selects or endorses.

In cooperative practice, directors frequently make suggestions born of their outside observations, contacts and experiences, which are found fruitful when worked up by operating management. However, most board decisions, though the function be exclusively of board concern, will find their roots in the depths of the operating organization. Indeed, to extend the metaphor, the entire plant may and frequently will ordinarily be conceived and fabricated before it reaches the board.

As a withdrawn perspective tends to enable a board to sit in weighty consideration and render mature judgment, that very remoteness from the heat of creative skill keeps it barren of original suggestive thought.

Contrarily, the man at the machine and the man who supervises its operation, the man who lunches with the prospect and the man who makes daily scrutiny of the ensemble of operations, are the dynamic factors of invention and design, be they of machine or method.

Initiation and formulation, practical trial and error, are habits of the individual. They do not lend themselves to the deliberations of assembly except in the final stages. So it is to be expected that operating management will conceive and the board conclude.

Here, the analogy of our constitutional scheme is close. It is not unusual for the executive to investigate, formulate a plan and present it to Congress for adoption, modification or rejection. A tax plan frequently comes from the Treasury Department, a foreign policy plan comes from the State Department. Whether with or without an accompanying proposed bill, a plan adopted no less represents the judgment and decision of Congress because it has been conceived, formulated and prepared elsewhere.

Again, we must repeat that such conclusion is full performance by the board. This is so although the information comes from operating management, although the plan has been prepared and formulated by operating management, although it is transmitted to the board with operating management's opinion as to its merit or demerit, although operating management counsels and advises the board concerning it and although it is left to operating management to execute it. All this, regardless of the nature of the function and though it may be reserved to the board, is operating management's job, its contribution to the teamwork. And if the board acts conscientiously in coming to a decision

based on its independent judgment, it has fully exercised its function.

The more efficient the executive branch, the greater its contribution will be and the less will be required of the controlling law-making body, be it Congress or a board of directors. The more invariable the acceptance of executive recommendations, short of a point where acceptance becomes automatic and unquestioning—as in the case of the so-called rubber-stamp congresses of the New Deal days—the greater is the indication of effective cooperation. Conversely, the frequency of veto spells rift that bodes ill for the enterprise, be it the body politic or corporate.

§ 166c. Operating Committees.

A word of caution will not go amiss at this point. Many large operating corporations are organized to include operating management groups or committees which function within the organization. These committees frequently come to conclusions which should be treated as "decisions" only as to current operating matters. When such judgments pass the operational scope, as they frequently do, they should not be accepted as substitutes for the action and judgment of the board. Here again, as a practical matter, such executive determinations are bound to reflect all the elements of a "decision" by the board itself, except the significant one of representing the judgment of the board.

This also works in reverse, though, naturally, it is not of common occurrence. When operating management takes its operating problems to the board—as it will often do if it has respect for the board's competence—

the board can and will counsel, suggest and advise. But then it is for the executives to make the decision.

§ 166d. Avoidance of Friction.

No enterprise can put its best foot forward if behind its effort is friction: whether between members of management, between operating management and the board, or between members of the board. All the constituents of operating management and of the board must harmonize; they must work like a team, in unison, to effect the common purpose.

§ 166d1. Through Recognition of Jurisdiction.

A practical method of avoiding friction and of effecting cooperation is found by resort to the basic principles we have outlined. Where there is disagreement between the board and management concerning a particular matter, determination of where that particular matter lies, whether it rests within the particular jurisdiction of the board or the delegated jurisdiction of management, should decide who should defer to the other's decision. If the matter comes within the sphere of operations, the judgment of operating management should prevail. If the matter is one involving the care, control and custody of the assets, or comes within the scope of the field of director-stockholder representation, the board's judgment should prevail.

§ 166d1.1. Examples.

A company selling its product through dealers is told that its dealer in a metropolitan area in which its sales are substantial, desires to retire. He is about to sell his yard to a competitor who does not handle the company's

products. The president of the company recommends that the company purchase the yard and continue the wholesale and retail business of the dealer to assure continued sale of its product in the area. Directors of the company are strongly of the opinion that the company's policy of not owning sales companies is a wise one. The president states that he is in agreement with this general policy; however he recommends deviation in this particular instance because (1) he does not want to lose the volume of sales in the territory to competitors, and (2) he is certain the outlet will not be unprofitable as an independent venture.

Here, the directors may properly defer to the president's judgment if the corporation can afford the purchase; the problem may be considered an operating one, i. e., one of keeping up sales, and within management jurisdiction. On the other hand, if the directors believe the capital expenditure beyond the corporate means, that decision is wholly within the scope of their jurisdiction since it involves the care and custody of the corporate finances.

Frequent examples are to be found in the field of labor relations. A board may feel strongly *vis a vis* union demands; it may feel strongly that labor is not entitled to a periodic increase in wages, that such a course merely breeds inflation and higher prices. Yet, daily, we find directors with such convictions yielding to the judgment of management that, as a practical matter, it is better to grant such demands, rather than run the risk of suffering disruptions of operations or morale.

However, when a crisis impends, the board must assert itself; the issue transcends confidence in manage-

ment and essentially goes to the preservation of the company's business and assets. So, for example, when in a period of strong competition, prices cannot be increased and shrinking profit margins endanger the company's ability to operate at a profit. Or when, as during recent years, increased labor costs have increased anthracite coal prices to a point where such increases have destroyed and are destroying the market for coal. In such a situation, a board would not only be justified but is required to make an issue of management's willingness to grant further labor demands, for the life of not only the company but the industry is at stake.

Similarly, when management seeks a pension plan and the cost of past service benefits threatens to take from stockholders an undue percentage of the value of their equity. Here, the trustee obligation of directors to their stockholders requires a firm and uncompromising stand by the directors.

But these are exceptional situations. Ordinarily, where difference of conclusion appears between management and the board and the scales of judgment teeter, if the issue is essentially an operating one, a director may properly be expected to take management judgment. Conversely, if the problem is one more susceptible of an outside judgment, a financial problem, a question of external conditions, skilled men on the board might reasonably expect management to manifest confidence in their more experienced judgment in an area where the board judgment should be supreme.

The situation is much akin to the judgments of federal administrative bodies; when they come to the courts, the judges approve them, though they may disagree, if the subject is one in which the administrative body may

be expected to be expert; a technical utility question decided by the SEC, a railroad question decided by the ICC, an aviation problem decided by the CAC, a telephone or telegraph issue decided by the FCC. But if the determination turns upon a question of law, since that is the field in which the judge is supposed to be expert, the latter's determination prevails to reverse the administrative opinion, if the judge disagrees.

§ 166d2. Extreme Measures.

Where management is in control and is efficient but dictatorial, it is better for the immediate corporate good that it have an inactive board; what it may sacrifice in efficiency by lacking the aid of a competent and active board will harm the corporation less than would friction between such a management and an aggressive and dissatisfied board.

Where the management is incompetent and at odds with an active board, the board must get more active and find new operating personnel. In any event, a means of cooperation must be found, or efficiency and profits are the victims.

Where friction exists, unless board members are primarily substantial stockholders or their direct representatives, the controversy will ordinarily be disposed of by the resignation of the dissenting directors, or by their being dropped if the management is sufficiently determined. For the very lack of incentive in directors to dissent, as indicated previously, will, in greater measure, induce directors to resign rather than lead or face an unpleasant controversy with management. And unless management's policies threaten dire corporate results, it is better for the corporate interest that the

friction be eliminated since its continuance poses threat for the ultimate welfare.

§ 167. —— Operating Management's Participation in Board Functions.

As board functions impinge upon the managerial functions delegated to the executives, so the actual exercise of power by operating management, subject to board control and decision, reaches into every function of the board.

§ 167a. Appointment of Officers and Compensation.

Take, for example, the selection of officers and fixing their compensation. This, above all, as to top officers, is an exclusive and nondelegable board function—one expressly charged to the board by the bylaws. Yet, in practice, it is the president of the corporation who suggests who his subordinates shall be, vice-president, treasurer, comptroller, secretary, and fixes their salaries, and since, in a successful corporation, the president ordinarily has the confidence of his directors, such selection is tantamount to appointment. This must necessarily be so, for however much effort is made by board members to become acquainted with operating personnel, it is the president who is most familiar with their esoteric vagaries, and it is the president who must find them compatible in everyday contacts and operations. And only the president can properly estimate their respective worths in dollars.

Similarly and analogously, though presidential and subordinate succession is primarily a board responsibility, though a board, above all, must see to it that the organization contains younger men ready to move up

when death or resignation take the older men, again it is the president who, on the basis of his more intimate contacts and knowledge, undertakes to move his subordinates about, while he is still in office, so that in the event of his moving on, the work of the organization may continue uninterruptedly.

Where the president is weak, futile or prejudiced, the situation, of course, is changed, and the board must be prepared to intervene; this, however, is the exceptional, not the usual case. Ironically enough, this situation may also prevail when the president is competent and strong, yet too strong and dominant, the type that weakens his sons and his associates — who demands "yes" men and discourages the men who could be his successors.

On the score of compensation, it is the president who, as noted, should know the particular value of his principal executives and they who should know the worth of their subordinates to the organization. The directors cannot possibly know these things. So it is the president who comes in with recommendations of increases from time to time, who, suggesting the man he wants appointed to a vacant post, also suggests his salary. At the organization meeting, when directors renew the tenures of the principal officers, the motion is invariably to appoint the following named persons at the existing salaries, unless the president thinks some one's salary should be raised and then it is he who makes the recommendation.

§ 167a1. Example.

An excellent example of the importance in practice of operating management in this field academically

vested exclusively in the board, and thus illustrating that it is cooperation, not prerogative that must govern in everyday corporate life, is found in the case of a company that suffered shrinking sales and profits, with consequent cessation of dividends, all resulting from an industry condition that threatened to be permanent. Immediately preceding the annual meeting and in anticipation of stockholder inquiry, one of the directors moved to cut directors' compensation by 50% and to reduce executives' salaries by 10% across the board. Another director objected, saying that at the subsequent organization meeting, those matters would come up when reappointing officers and fixing their salaries. The objection was found valid.

Thereafter, at the organization meeting following the annual election of directors, the president recommended the reappointment of the officers and recommended that their salaries be continued without reduction. The director who had previously sought the reduction renewed his objection. The president explained to the board that he was effecting administrative economies throughout the organization by eliminating and consolidating jobs, by retiring older men and not filling their places, that he was increasing the tasks and the burdens of the top executives, that they were working under conditions of strain and distress, and that a blanket reduction would hurt the morale of the very men he was depending upon to effect economies and improve results.

Thereupon the board ruled out blanket decreases and made inquiry as to the status of each top employee, his particular duties, when last he had had an increase of salary, what a similar job paid elsewhere in the industry, etc. Finally, after such a detailed review, the board

found itself in agreement with the president and approved the latter's recommendation.

§ 167b. Stockholder Relations.

Since it is the director who represents the stockholder, it is logical to consider the matter of stockholder relations within the keeping of the board. Yet, as we state elsewhere, logic also requires that the brunt of contact with stockholders be borne by the executives—ordinarily the director meets stockholders at the annual meeting once a year, if then. So that here again we find a matter where, though academically the legal responsibility is the director's, the practical details of the relationship will be handled by operating management, with the obligation on the board to keep itself informed of the manner and effectiveness of the execution and effect of management's efforts.

§ 167c. Charitable Contributions.

A less important, but nevertheless an excellent example of a function legally to be exercised by the board but which in practice is properly formulated and exercised by the executives, is found in the case of corporate charitable contributions. We discuss elsewhere the legal and practical aspects of the corporate charitable contribution. Here it serves as an example of a function of the board which is usually exercised by passing on a recommendation of the president for approval of a gross annual amount to be allocated to such charitable causes, in such amounts as the operating executives may determine. The reason for this is obvious since it is the executives to whom the particuar appeals and upon whom the particular demands are made; and it is not the

board, but the executives who, on the firing line—and the metaphor is not inapposite—can properly appraise the worth of the cause and the good will that a contribution will bring to the corporation.

The exercise of the board function as we have described it is not invariable; frequently board members who are active in community affairs have decided ideas on the subject. The practical effect of precedent here, as is usual, often serves to make questions academic; usually, last year's detailed list is submitted to the board as this year's, with minor changes. But the fact remains that the executives are really the apportioners; the board usually confines itself to determining what the aggregate should be after the president has made his recommendation.

§ 168. —— Board Effectiveness.

Whatever its functions, and whether they be exercised solely or jointly, the board should make itself effective.

Whether this is easy or difficult largely depends upon the executives. Operating management can conceal or reveal, as it prefers. It can encourage the board to action or discourage it by withholding information. It can put problems before the board for decision or decide them itself without consulting the board.

Nevertheless, a board that desires to function has no excuse for inaction. Its legal and practical powers are such that it cannot be short of effectiveness without its acquiescence.

If executives are "biggity" and uncooperative, the board has many practical aids to whip them into line. When the board acts in unison, it holds the whip hand;

it needs only to exercise it. It can limit or withhold appropriations, revoke authority and, in the extreme instance, discharge when occasion demands.

Where management tends to seek a lax board, board members who seek to be active must have a working knowledge of what functions they should properly exercise in order that they may stand firmly on the ground that is theirs. They must equip themselves with the technical knowledge necessary to meet better equipped executives. And when they undertake to act, they must not weaken their position by making arbitrary or unenforceable decisions.

Directors cannot excuse inaction, as an operating management cannot justify an inactive board, with the explanation that some trusted individual board members advise with the executives. The fact that such a trusted adviser happens to be a board member does nothing but substitute a prime minister for a legislative assembly. Even a Hitler had "trusted" advisers.

A federal trade investigation witnessed a utility executive justifying the corporate acquisition of another large utility without board action by his consultation with "certain influential members of the board." This, obviously, is corporate alibi, not corporate action.

A board may find itself in a difficult position when it seeks to challenge a management that is producing net profits. However, a board should not permit the continuance of losing operations simply because overall operations produce a net profit. This was the nub of much dissatisfaction with O. P. A. regulations that fixed prices of some products at which they could not be manufactured simply because the consequent losses merged in an overall net corporate profit.

But even a flaccid board can come alive—and must, on occasion, for its own protection. Why should a man take the responsibilities of a directorship unless he means, by vigilance and care, to protect himself from its pitfalls? The following chapters expose these pitfalls and demonstrates that some of them—like hunters' traps—are frequently obscured.

A director may and should have confidence in operating management. But that should not be akin to the confidence of the Mexican fisherman who, when asked by the prospective sportsman if he carried life preservers and fire extinguishers, replied: "Of course not, I do not expect any trouble. And why do you come if you have no confidence that nothing will happen?"

On a board, as elsewhere in this world, a man's basic protection lies within the range of his own caution and resource. Self-protection is usually the sum of diligence and self-restraint. Yet, it may aptly be said that directors rush in where lawyers fear to tread by taking jobs they are not prepared to perform.

A director cannot look to management for protection, either for himself or for the stockholders he represents. His job is to furnish that protection for himself and the stockholders. He cannot, with safety to himself and the stockholders, weakly evade his responsibilities; when he does, he merely adds negligence to the list of counts against him.

Directors must not stress self-protection. The interests of their stockholders and the corporation come first; those of the director second. But, inevitably, one follows the other. When the directors do their job for their stockholders, they automatically have protected themselves. However, paradoxically enough, when in

a misguided search for self-protection, a weak or cowardly board tries to run from a problem, it is simply setting up a situation where it is creating not self-protection, but possible liability for negligence. And, conversely, by the mere act of facing the problem and bringing its judgment to bear upon it, a board not only exercises its functions but builds the shield of self-protection the directors seek, be the consequence of their judgment good, bad, or indifferent.

CHAPTER XII

Exercise of Functions—Dividends

§ 169. Function of Board.

§ 170. —— Earnings Adequate.

It is the duty of operating management to produce earnings needed for the maintenance and development of the corporate business. Once earnings have been produced, it becomes the duty of the board, since the corporate finances are in its keeping, to allocate them to the various needs of the business.

When earnings are available, the power to declare them as dividends vests in the board. It is for the di-

rectors to determine rate, time and manner of payment, except as they may be limited by contractual (loan) obligations or by restrictions in the corporate charter or the applicable corporate law.

While the Courts will exercise their jurisdiction to prevent an illegal distribution of the corporate funds, or other illegal abuse of the board's power, to the extent that the board's action involves exercise of its discretion, the courts will not interfere. If, as is so frequently the case, stockholders feel dividends declared are insufficient, their sole remedy is to seek to replace the directors, since, here, the directors' judgment reigns supreme.

§ 171. —— Earnings Inadequate.

When the corporate earnings are insufficient to permit payment of adequate dividends, it is the business and function of the board to ascertain the causes and formulate the remedies. When no remedy can be found, it is the duty of the board to recommend liquidation of the enterprise, so that the stockholders' sterile investment may be returned to them.

§ 172. —— How Function Exercised.

The first facet of the task of declaring dividends is to determine the earnings of the business; the second to determine the amount available for dividends. This involves a prior determination of how much of the earnings are to be retained in the business; only the balance will be available for dividends.

While we discuss these questions academically, we must not lose sight of the practicalities. Except where

dividend policy is being formulated for a new concern, practically all companies have an existing dividend policy. These vary. Some rest upon a determined policy to pay a fixed, regular dividend regardless of current earnings; others to pay a percentage of or amount from last years earnings; still others a percentage of or amount from next year's earnings, as budgeted or otherwise forecast.

The obviously soundest policy is that of the company, with adequate surplus, that pays a regular dividend, constituting an accepted percentage of steady earnings, and increases its dividend as its stable earnings grow. For such a company yearly discussion of "charge-off," "write-downs," "retained earnings," and the like, will have no effect on dividends or dividend policies. For new companies and companies on a hand-to-mouth dividend basis, consideration will be needed to determine the amount of current earnings and the amounts to be retained therefrom for corporate purposes before the amounts available for current dividends are ascertainable. Ultimately, experience and trial and error will merge the annual discussion into a fixed dividend policy.

§ 173. —— Determination of Earnings Available for Dividends.

At the base of dividend declaration, as noted, is earnings. The determination of amount of the earnings is ordinarily an accounting matter that does not involve directors' consideration. However, when accounting determinations may rest on bases of policy, directors' intervention may be needed. And when the policy adopted results in an earning statement that varies from one that truly reflects the situation from a dividend

standpoint, directors may properly ignore the formal earning statement in assessing the dividend realities.

Examples in this category are found among others in the fields of inventory write-down, depreciation and charging to expense items that should be capitalized.

Where there is strict application of the cost or market rule, whichever is lower, to raw material, an inventory write-down finds true reflection in an earning statement. But when a conservative business or tax-saving policy applies a percentage rule of thumb to unsold finished merchandise, by deducting a fixed percentage periodically as it remains unsold, the arithmetical computation of "loss" and corresponding deduction from current earnings may have the effect of creating cash throw-off for tax savings rather than truly reflect true loss deductions from such earnings for dividend purposes.

As will appear, the subject of depreciation offers similar example of the need for both directors' determination of policy and keeping in mind for dividend purposes true earnings as distinguished from book earnings.

A cogent example of charging to expense items that should be capitalized was found in the case of a utility that was compelled by SEC rules to include as deduction from earnings amortization of pension costs which properly was to be classed as a capital item. Though the annual earning statement showed a substantial reduction by reason of the forced inclusion of this annual item, the directors ignored it in declaring dividends.

§ 174. —— Retained Earnings.

Once earnings for dividend purposes have been determined, the next question is what portion shall be retained in the business.

In many cases this determination is pragmatic. In the utility field the current practice born of the need of equity financing for funds for expansion is to pay dividends of 70% to 80% of net earnings and since utility earnings are steady, this falls into a dollar pattern with each company, with increase proportionate to earnings increase. In other companies the dollar pattern of dividends has been accepted by management and shareholders and this is adhered to, with reliance on surplus in lean years and declaration of extras in affluent periods.

However, even in such companies, times occasion a review of practices and a need for viewing the elementals that should properly determine dividend policy.

A proper scale of retained earnings, adequate yet not excessive, should be fairly determinable from past experience and reasonable and intelligent projections for the future based thereon. These should permit determination of the amounts to be reserved for bad debts, taxes and pension obligations, for depreciation, depletion and obsolescence, for retirement of long term debt or preferred stock beyond sinking fund requirements, for expansion of facilities, working capital or inventory, and, finally, to create an earned surplus fund available to maintain a regular dividend during periods of stress.

Manifestly, some of these items brook no debate; the amount is readily determinable by the use of accounting formulae which permit no deviation. Others, however, may breed controversy and justify more extended consideration of policy and its consequences. Necessarily, policy will vary between a new concern anticipating growth and an old concern that feels it has reached its limits of normal expansion. It will vary between an

enterprise engaged in a dynamic industry and a company in a depleting one.

§ 174a. Depreciation, Depletion and Obsolescence.

If wasting capital assets are to be repaired or replaced, reserves must be set up for the purpose from current earnings, else the overall capital value of the corporate assets will be reduced. Indeed, the cash equivalents of such shrinkage do not represent "earnings." To the extent that current expenditures are made for maintenance of capital assets, they avoid and negate current depreciation.

To the extent assets deplete, as in the case of natural resources such as oil and minerals, or become obsolescent because of improvements in the art of production, such as in the case of productive machinery, the cash equivalent of such depletion or obsolescence constitute true deductions from current earnings available for dividends, since they represent a replacement of the wasting capital assets which constitute the corpus of the stockholders' investment.

Nevertheless, such deductions, constituting cash throw-offs, though available to reduce taxes, are often, at least in part, to be deemed available for the determination and payment of dividends. It is no secret to the taxing authorities that the 10% annual allowance for machinery depreciation, or the 3% or 5% annual allowance for plant depreciation, resulting in a total book write-off after 10, 20 or 30 years, leaves a physical asset with a continued life and usefulness. So the amount set aside for annual depreciation may not always truly serve to reduce current earnings; it may do so for tax purposes only.

The problem thus posed for directors in determining the amount available for dividends is intensified by the provisions of the 1954 tax law which add optional methods of expediting depreciation and taking tax deductions that far exceed actual depreciation. Formerly, "fast" depreciation was a defense expedient designed to encourage and permit capital expenditures for increased production needed during the war effort. Now it has found such acceptance (the NAM reported that 45% of 167 companies surveyed had adopted "fast depreciation") that Treasury Secretary Humphrey has asked Congress to modify the policy in the interest of avoiding severe reduction in corporate tax collections.

In any event, fast depreciation substantially changes the standard earnings statement, so that, in many cases, the earning statement for tax purposes neither truly reflects actual earnings nor furnishes an adequate picture for directors' consideration of dividend declarations.

The effect of a fast depreciation write-off, with general application to many types of write-downs, is illustrated by a financial analysis of the Dow Chemical Company when its quarterly earning statement showed a decline in per share earnings from 43c. to 30c. The analysis showed that one factor resulting in the lessened net was "a huge increase in Dow's depreciation and amortization of plant and equipment, augmented by five year write-downs under government certificates of necessity." Dow's treasurer noted an increase of depreciation from 1952 low of $33 million to a 1955 high of $75 million.

The analysis stated that as a result of these write-downs; the cash intake would greatly exceed earnings

as shown on the current profit and loss statement, that they would provide funds for plant expansion and to retire debt, that they would also effect tax savings. It pointed out that though current earnings would thereby be reduced, the effect would be to increase future earnings.

For present purposes, it should be noted that had the company not undertaken to employ its additional cash generated by the write-offs for expansion, it would have been available for dividend purposes, despite—in truth because of—the write-offs.

In short, the effect of taking depreciation is to provide a cash throw-off available for corporate purposes. If the actual depreciation of assets and the depreciation charge-off are equal, then the cash produced by the latter is needed to restore or replace the depreciated assets and is not available for other purposes. For example, Oklahoma-Mississippi River Products Line advised stockholders that since accelerated amortization would result in higher income taxes after the first five years of operation of its pipe line, it considered it good accounting practice to reduce earnings meanwhile by an amount set up in a reserve account against income taxes payable after five years.

If, on the other hand, as is usually the fact—particularly where "fast" depreciation is taken—the charge-off exceeds the actual depreciation, then the difference represents cash available for other corporate purposes.

§ 174b. Debt.

Reserves for long-term debt ordinarily would seem to be a wise dictate of a policy of business caution. However, it must be remembered that enterprises of a

particular nature thrive on the leverage furnished by debt and reserves which contemplate full payment of long-term debt cannot always be justified. Public utilities and railroads fall into this class. A reasonable debt ratio should be maintained by this type of company, both for its current tax advantages and for the leverage it affords its equity investors. Industrial corporations with readily mortgageable fixed assets may also come into this category. Where prudent management does not require full amortization of existing long-term debt, the opportunity to pay current dividends is increased correspondingly.

§ 174c. Expansion.

Similarly, setting up reserves for expansion which is more in the realm of wishful thinking than in actual contemplation will work unjust results to current shareholders.

It is possible too that expansion potentials, entirely justified, may call for greater capital expenditures than the corporate net income justifies. Where this occurs, it becomes the function of the directors to seek additional capital either from the stockholders or from other sources, by sale of stock or by contracting debt. It is not fair to today's stockholders to deny them dividends so as to reinvest and retain earnings, year after year. (We are not here considering the no-dividend or low-dividend corporation, which we discuss later.)

In the ordinary corporation, ordinary potentials for growth and expansion can and should be met either by current capital expenditures or by creation of reserves in a reasonable amount. No corporation can afford to be static, particularly in this period of sharp competi-

tion. Stockholders' desires for dividends must yield, in reasonable measure, to this corporate need, else ultimately there will be no source from which dividends can be paid.

§ 174d. Surplus.

Here again, there should be reasonable provision for building surplus from current earnings for greater corporate stability and credit. But here again, current stockholders should not be asked to make unwarranted sacrifice for future holders of the stock.

§ 174e. Working Capital—Cash Position.

It must be remembered, however the arithmetic figures may justify dividend conclusions, that dividends must be paid in cash and that they must yield to the cash requirements of the business, since bills must be paid in cash. Consequently, the primary requisite of dividend payment is cash not required for other and more mandatory corporate cash requirements.

§ 175. Stockholders Entitled to Adequate Dividends.

Ordinarily, stockholders are entitled to a dividend return compatible with the value of their investment.

Corporate earnings may be likened to the lifeblood flowing through the arteries and veins of the body. Every part of the body needs to be adequately supplied. So the corporation that produces only enough in earnings to defray the cost of its labor and management and leaves nothing for its stockholders, is an anemic structure that is not functioning properly. Unless it can also produce for its stockholders, their in-

vestment is unjustified, and since, without their investment, neither labor nor management can be compensated, obviously the satisfaction of the needs of the one group cannot be justified without similar satisfaction of the other.

As was pointed out in the 1953 annual report of the United States Steel Corporation, United States Steel's 300,000 individual and institutional shareholders have an invested average of $8000 each for the tools of production that provide jobs for some 300,000 employees. The report says: "Investment in new tools of production is the only way that new self-sustaining productive jobs can come into existence . . . It cannot be done without stockholder participation."

§ 176. —— **Exceptions.**

In given situations, inadequate or even no dividends may be justified.

In a new enterprise, it may be necessary to withhold or limit dividends to build up needed working capital and surplus. Even in a going concern, on occasion, the stockholders' right to adequate dividends may properly be subordinated to the need for making up losses, building inventory, expanding, or other temporary but immediate purposes. Where such a need continues for any substantial period, a stock dividend may be substituted wholly or in part for a cash dividend, provided the requisites for a legitimate stock dividend are met.

These are temporary situations. Where inadequate dividends are more frequently encountered is in the long-range situation, the corporation that adopts an inadequate dividend policy deliberately as a means of reinvesting the corporate earnings for the ultimate

benefit of the stockholders in corporate expansion and individual tax savings.

Here, when a board has made its policy apparent, stockholders who disagree must either undertake to change the personnel of the board or sell their stock and reinvest their funds in a corporation that has a contrary dividend policy.

While the stockholder's ability to sell his stock is no remedy for corporate abuse, it is, an occasion, a legitimate means of fitting stockholder aims and corporate policy. Stockholders have various notions and purposes; corporate managers have varying policies. They will not always agree; but the stock market is, in some respects, like a shop with a varied assortment of goods designed to fit the varying needs of many buyers. So an investor may exercise a free choice, and as he buys into a speculative company rather than a conservative one, a public utility rather than a mining company, he may buy into a generous dividend company, if he wants current income, and get out of a niggardly dividend company whose stockholders generally seek capital gains rather than current income.

§ 177. —— What Is an Adequate Dividend Return.

Stockholders should have all the net earnings the corporation does not require for its legitimate current and future needs. The corporate needs should be curtailed, where practicable and necessary to yield the stockholders a fair return on their investment. To put it differently, stockholders are entitled to a maximum return on their investment, compatible with safety and the needs of the enterprise for legitimate and fruitful expansion.

What is an adequate return is determinable by resort to book value and the standard of return of investments in that particular industry. Obviously, stockholders of a company engaged in an uncertain and speculative industry should have a better return than those of a bank or a public utility.

While a prospective purchaser will measure dividend return by what he pays for the stock, i. e., its market value, the true base may well be book value, provided it is the true realizable value of the assets. On occasion, particularly in a conservatively managed corporation, the working values of depreciated assets and unvalued assets, such as patents and goodwill, will make book value less than the actual value of the enterprise. Generally, however, it may be concluded that book value more truly represents the value of the stockholders' investment, the amount upon which capable management should be able to earn an adequate return. (And the difference between book and market value of the stock may generally be a clue to the competency or incompetency of management.)

If management cannot produce adequate dividends, the stockholder is better off if the concern liquidates and frees his capital for investment elsewhere. While advocates of liquidation are unpopular, since liquidation works hardship on employees and communities, it must be remembered that one of the safety valves of the free enterprise system is the elimination of inefficient and noncompetitive units that tend to injure efficient competitive price structures by contributing and wasting their capital in an effort to compete.

§ 178. —— Dividends Should Not Be Excessive or Otherwise Unjustified.

However, dividends should not be unjustified, either in declaration or amount.

Though stockholders seek income, they do not welcome excessive or unjustified dividends, since they are mindful of the need of safety of their principal.

A Los Angeles Stock Exchange survey found 738 of 1115 shareholders preferring a corporation with a conservative dividend policy; 969 chose companies paying 40% to 80%; 221 liked low paying companies. Only 65 favored companies paying out most of their earnings and financing expansion by stock sales.

An inquiry made of its 1672 stockholders by the management of Sterchi Brothers Stores, Incorporated, as to dividend policy resulted in 900 stockholders advocating a reduction of the existing dividend rate.

Nor are directors justified in continuously dissipating surplus to pay dividends not currently earned, for ulterior purposes, such as to keep shareholders quiet and thereby unjustifiedly perpetuate management's jobs or control, to unduly increase the market price of the stock, or to enable new stock to be issued and sold at an unjustified price. Such practices are as fraudulent as the concealment of earnings or the lessening of dividends to depress the market price of the stock so insiders can defraud unsuspecting shareholders by buying their stock at reduced prices.

Just as improper charge-offs should not be permitted to minimize dividends, so dividends should not be declared out of improper sources. So write-ups to market or appraised values, even if otherwise justified, are not realized profits out of which dividends should be de-

clared. Similarly, depreciation and other reserves should be adequate before dividends are declared from current earnings.

§ 179. —— Holding and Investment Company Dividends.

If the enterprise in question is a holding company, it may properly function like an investment company and pay out in dividends practically all its receipts, since its need for retained earnings is nil and its costs of operation should be small, if it is legitimately and properly managed. If, however, as was contemplated in the old utility days, the holding company was conceived as a source for financing its operating subsidiaries, it would have need to retain earnings for expansion purposes.

Indeed, practically all investment companies pay out practically all their income earnings as dividends and distribute, as well, all capital gains realized on the sale of securities during the current year.

Where the enterprise is a public utility largely capable of financing expansion needs by bondable additions, its percentage of retained earnings for this purpose need be slim compared with those of an industrial company that cannot or should not attempt to incur debt for plant and machinery expansion. So, as noted, it has become customary for operating electric light and power companies to pay out 75 to 80% of their earnings after taxes. This represents a considerable change in management ideology, due principally to the need to finance needed expansion through common stock issuance and sale, since without a full dividend rate, stockholders and others cannot be induced to buy ad-

ditional common stock at prices which produce a maximum of capital with a minimum of stock dilution.

§ 180. —— Advantages of Adequate Dividend Policy.

§ 180a. To Stockholders.

The advantages to a stockholder of a liberal dividend policy are obvious. Increased income is the primary benefit and concurrently, since a principal factor of market price is the dividend yield, larger dividends mean price appreciation.

Of 1375 shareholders who answered a survey query of the Los Angeles Stock Exchange, 811 said they bought for the income, 426 for income and possible price appreciation and only 131 for market gain alone. Whether a shareholder seeks income or price appreciation, he gets both when the dividend yield is legitimately increased. The importance of market price becomes of paramount importance, of course, when the shareholder seeks to realize on his investment.

Of course, the stockholder who is in the tax conscious brackets, suffers tax-wise when he receives large dividends. He is better off when the corporate earnings can be retained and reinvested to advantage; the increased earnings, regardless of yield, will also produce market appreciation. To such a stockholder, a liberal dividend policy is a disadvantage; he is better off with tax-free bonds or the type of low-dividend paying corporation we discuss later.

Nor can there be any doubt that the existing utility practice of paying out high dividends and then going to the same stockholders for more capital is a wasteful one to the stockholder who pays out a substantial por-

tion of his dividends in tax payments and then must put up additional capital to avoid dilution of his stockholdings. It would seem more advisable to let the corporation reinvest his dividend for him without the tax loss.

§ 180b. To Corporation.

§ 180b1. Market Value Affects Corporate Standing and Credit.

The factor of market value, once deprecated by management, is also important for the corporation. It is taken by the business and investment world as a reflection of the credit and standing, the affluence and stability of the corporation and its business. Management discovers this when it seeks credit, when it asks an AA rating on its bonds, when it endeavors to raise capital by the sale of its stock, to its shareholders or others, through underwriters or dealers, when it discusses merger or consolidation. And management owning control discovers this when it attempts to retire and sell its control stock, and its heirs discover this when they attempt to find a purchaser for the control interest.

Management's appreciation of the corporate value of a liberal dividend policy was illustrated by Union Electric's insertion of a large display ad in the Wall Street Journal headed "Union Electric increases quarterly dividend 5¢ a share."

Again, however, it must be noted that increased earnings resulting from reinvestment of earnings that might otherwise have gone to shareholders as dividends, will move a company's stock up in the market. Once it becomes known as a reinvestment rather than a yield situ-

ation, its stock will attract that type of investor. However, if the major companies in an industry establish a dividend practice, it may be found difficult for a single company to undo it.

§ 180b2. Liberal Dividend Policy Produces Stockholder Good Will.

Manifestly, as is pointed out elsewhere, the stockholder who is well treated dividend-wise is the satisfied stockholder to whom management can look for support and cooperation. He is the stockholder from whom management can seek money for expansion through equity financing, to whom management can look for support when "raiders" appear on the scene to disturb management in its control. The policies of our public utilities, notably American Telephone and Telegraph Company of industrials, such as General Motors, attest management recognition of the link between liberal dividend policies and financing expansion through stockholder contributions.

§ 181. —— Limitation of Dividends.

§ 181a. Corporate Purposes—Expansion.

There are situations where directors are called upon to determine whether the best interests of the corporation and its stockholders are served by a liberal dividend policy or by retention and reinvestment of earnings for expansion and other capital purposes. Examples are furnished by railroads like the Illinois Central, which use large current earnings for capital improvements and debt reduction, industrials, like United States Steel, which make vast plant additions and Montgomery

Ward, which built large surpluses for future needs, the leading chemical companies, which plow back a large portion of earnings into research and development, and generally, by the oil companies, which reserve a large portion of their earnings for future acquisition, prospecting and development. Enterprises with depleting assets need to adopt such a policy, else they will ultimately find no subjects for their management skill and enterprise.

These companies necessarily pay a small percentage of their earnings in dividends. They make no secret of their policies. Their financial reports are notice to investors that they are buying into such an enterprise; consequently investors are not in a position to complain.

The consequence of such a policy in terms of capital appreciation is furnished by the figures on Superior Oil Company, listed on the New York Stock Exchange. In 1949, its stock sold at a low of $127 per share; in 1955 at a high of $1040. Meanwhile it had paid dividends at the rate of never more than $3 per annum.

§ 181b. Stockholders' Purposes—Tax Avoidance.

Where management has large stockholdings or seeks to protect large stockholders from payment of normal taxes on dividend income, we find corporations retaining earnings for the purpose of lessening dividend payments, thus favoring capital appreciation over yield.

This motive goes hand in hand, when public financing is required, with an effort to offer stock to subscribers at low rather than at high prices, so management, more mindful of its individual interest than of that of the public shareholders represented by the corporation, may more readily subscribe to its proportion of the new

stock and thereby avoid diluting its working stock control, although the issuance of the new stock at unnecessarily low prices works an unfavorable overall dilution.

Since the theory of our income tax system is that undistributed profits are savings and savings are part of the concept of taxable income, section 102 of the tax law imposes upon corporations that improperly accumulate earnings a special penalty tax. Heretofore, this has been assessed only in exceptional cases, largely in cases of small or closely held corporations used as a device for tax avoidance. However, in a study prepared for the joint committee on the economic report, it was pointed out that this type of tax avoidance is also widespread in the larger, publicly held corporation.

The tax avoidance motive is almost endemic in the corporation where there is a large majority stock interest. And it is here more discernible. That is why such corporations have largely been within the area of enforcement of section 102. Even where a single group has a minority interest in a public corporation that dollar-wise is substantial, the tax avoidance motive will frequently be found to exist.

One need not be unduly wealthy today to be found in a class that prefers a corporate situation where earnings are "plowed back" to increase the capital value of the stock, rather than paid out in dividends that largely disappear into the greedy maw of the tax collector. Where one is wealthy and in control of a public corporation, one might well be found to say, in a moment of extreme frankness, as one tycoon did: "I'll be damned if I help that so-and-so Truman collect any taxes for his political handouts" as his reason for avoiding dividend payments.

Illustrating the common denominator between dividends and taxes, in a suit instituted in Philadelphia to direct Bankers Securities Corporation to pay dividends on the common stock, the stockholders charged that the company had withheld paying dividend arrearages on the common stock for the benefit, tax-wise, of the principal stockholder, a member of management. While, almost simultaneously, a suit was filed in Baltimore, to require Tri Continental Corporation, an investment company, to declare larger dividends, the plaintiff alleging that such a course would result in tax savings for the corporation.

The lack of enforcement of section 102 and the inability of stockholders to enforce their right to adequate dividends both stem from a common source, the difficulty of demonstrating that tax avoidance is the motive for accumulating surplus to the detriment of current distributions. The stockholders' inability is even greater than that of the taxing authorities because of the salutary rule that the courts will not interfere with corporate policy where it represents an honest though unjustified judgment of the directors.

Where the effort is to retain earnings to avoid income tax consequences to the larger shareholders, it may take the form of exaggerating the amounts required for reserves, taking excessive charge-offs or write-downs, or charging to expense items that should be capitalized. In this connection, it might be well to note at the outset that for tax or other business reasons, good or conservative business practice may justify items chargeable against earnings, yet for dividend purposes, such deductions may realistically be viewed with the proverbial grain of salt.

§ 182. Dividend Policy and Practice.

Dividends are declared, wherever possible, as the result of an underlying dividend policy arrived at by study of the past and a reasonable estimate of the future. The purpose of such a study is to determine how much a company can pay and can continue to pay in the foreseeable future. The guide to the future lies in the past. Here determination of dividends and determination of retained earnings meet on common ground. What were earnings in the past? What has been their rate of increase? What expansion has been financed in the past that should promise increase for the future? What is the trend of costs? Cash position? Need for retained earnings? Each company will furnish its own answers but adequate consideration should evolve satisfactory answers.

§ 183. —— Source of Payment.

While necessarily dividends are paid out of cash accrued from past earnings, psychologically at least, they are generally measured by an expected flow of current earnings.

§ 184. —— Example.

In declaring a 50¢ quarterly dividend John E. McCarthy, president of New York City Omnibus Corporation said the directors planned to continue quarterly dividend payments through the year and set the figure because they "feel that is the minimum we will earn . . ."

§ 185. —— Regularity.

The need is for a dividend rate that can be maintained, lacking unforeseen circumstances. Regularity of dividends is a prime requisite. Here some measure of conservatism should prevail since it is always possible to declare extras and increasing the regular rate is painless, while reducing or passing dividends is a painful and undesirable process.

In the Los Angeles Stock Exchange survey, it was found that almost 90% of the stockholders sought a regular rate of dividends, and half said they would prefer a lower rate with extras, rather than one that could not be maintained.

§ 186. —— Extra Dividends.

Nevertheless, where it is possible to add customary extras to a regular dividend, directors do so. Extras serve a needed purpose. But markets will not give to extras the same evaluation as it will give a regular dividend. And extras also have the vice of year-end and other infrequent and irregular dividends; the practice is unfair to stockholders who need to sell and cannot wait out the extended period. So a policy of declaring extras should not be unduly or unnecessarily pursued.

In the case of companies, like utilities, where budgets competently prepared should be available to prognosticate earnings, it is a reflection on the ability of the management to make it a practice of supplementing regular dividends by extras. Such a management—where earnings should be determinable because of stability of operations and their results—should be in a position to fix and pay adequate regular dividends and extras

should be what the word connotes, unusual, not usual, dividend throw-offs. The situation, of course, is different in the case of the industrial corporation with uncertain and irregular business periods of feast and famine; here a more or less regular practice of extras may sometimes be called for.

§ 186a. Transition from Extras to Regular Dividends.

The newspaper dividend news furnishes evidence of companies that paid extras until they were convinced they could increase their regular rates.

So we find Standard Oil Company of New Jersey announcing that it would discontinue its policy of designating part of its quarterly dividend payment as "regular" and part as "extra."

Similarly, to quote at random, since almost daily examples are available, Continental Casualty Company, in lieu of a regular 50¢ quarterly dividend and an annual extra of 50¢, announces it will thereafter pay a 65¢ regular quarterly dividend; Continental Assurance Company increases its 40¢ quarterly dividend to 50¢ in lieu of paying a 40¢ extra annually; Joseph Dixon Crucible Company votes 75¢ quarterly instead of 50¢ and a $1 annual extra; and, finally, Avon Products, in lieu of an extra stock dividend, increases the regular cash dividend.

That a need to retain a policy of "extras" may exist is illustrated by the M. H. Fishman dividend policy. This company paid a regular quarterly dividend of 15¢ and paid a 10¢ extra in March, 1951. However, it was not found expedient to pay an extra in the subsequent years until one was declared in March, 1954.

§ 187. —— Continuity of Dividends.

Even more important to the corporation, its market credit, standing and good will, than regularity is continuity of dividends. Regularity involves a continuous and unvarying minimum; continuity the payment of some dividend each year for a continuous and unbroken period. The importance of this factor is demonstrated by the releases of brokerage houses and stock exchanges which collate dividend paying companies in groups, according to the number of years they have continuously paid dividends. For example, the American Stock Exchange says: "For periods varying upwards from a decade to more than a century, the owners of 336 common stock issues traded on the American Stock Exchange have been receiving dividends every year. A roster of these dividend paying common stocks arranged according to industrial classification is contained in this booklet."

§ 187a. Examples.

That continuity is a source of pride to the companies themselves is demonstrated by the celebration by the Pepperell Company of the 100th anniversary of its unbroken dividend record, and by the content of dividend notices published by many companies, for example: The Liquid Carbonic Corporation heads its published notice: "21st Consecutive Year"; while the Lane Wells Company labels its current payment as "Dividend No. 67," The American Metal Company "Dividend No. 111," Copper Range Company "Dividend No. 107," and Allis-Chalmers "Common Dividend No. 119," "Preferred Dividend No. 30."

The New York Stock Exchange reported that, as of 1955, 186 listed companies had paid dividends in every quarter for 25 years or longer.

In this element of continuity lies the benefit to stockholders not only of receiving their dividends periodically, but of knowing they can count on getting them; as well as the appreciation and stability of market prices for stocks that offer new investors such assurances.

§ 188. —— Timing.

Another factor of importance for the board that desires to formulate a dividend policy that will best serve the company and its stockholders is the timing that enhances regularity. Many stockholders depend on their dividends for the needs of everyday living and the ability to rely on regularity of payment becomes an asset that breeds stockholder satisfaction.

A dividend should not only be regular in amount; it should be paid at regular times; it should not be paid at irregular intervals. Even if annual continuity is preserved, a dividend or dividends irregularly declared lose much of their value and effectiveness. A dividend should be declared for a particular period, preferably the quarter just past, payable out of, but not dependent upon, the earnings for that period.

§ 189. —— Anticipatory Dividends.

Some companies declare dividends for a future period in anticipation of earnings; in some cases a number of dividends are declared in advance. So we find Curtiss-Wright Corporation in January declaring four quarterly dividends payable in the following March, June, September and December, respectively. And we find

Colorado Central Power Company, in the same month of January, declaring three monthly dividends, payable respectively in February, March and April respectively. This of course is a most unusual practice.

§ 190. —— **Frequency.**

Dividends, like financial reports, should not only be regular, but frequent; for dividends, like financial reports, are a means of transmitting information to stockholders respecting the condition of the company. Our daily lives proceed at too fast a pace to justify a wait of a year for reports or dividends. Even semiannual payments are undesirable; the advantage and desirability of a quarter-annual reports and dividends find growing acceptance.

Though some companies pay dividends annually, and some semiannually, the better practice and the most common is to make quarterly payments unless the nature of the business is so unusual as to preclude so doing. Where the practice of annual declaration finds plausible justification, there is no reason why the amount of annual net income apportioned to dividends, though realized in a single quarter of the year, and though declared annually, should not be disbursed to stockholders in four quarterly payments, per the example of Curtiss-Wright previously given. For example, a Southern race track that has a single meet from January to March and is closed down the rest of the year, declares its dividend on a single annual basis. It could, as readily, make the same payment in four installments.

A long interval between dividend payments, a full year or even six months, detracts from the desirability

of ownership of the stock. The stockholder who needs to sell may be able to wait three months so he will not lose his income return, but six months or a year usually means that he must sacrifice his next dividend payment and the longer the dividend interval, the greater the payment and the larger the loss. Besides, a stock usually sells off following a dividend payment but recovers gradually as the interval before the next payment lessens. Obviously, when the payment is made annually, the stockholder must not only await the dividend date but must hold for a considerable period thereafter, or suffer corresponding loss. In these respects, the situation is comparable to that of the depositor in the savings bank and the trend in that field of speeding the cumulation of interest furnishes a parallel with the tendency in the corporate field toward quarterly declaration and payment of dividends.

§ 190a. Quarterly Payments the Common Practice.

Dividend notices in the financial pages disclose that corporations that formerly delayed their dividend declarations are turning to quarterly payments: For example, "Erie Railroad Co. directors at a meeting yesterday decided to place the common stock on a quarterly dividend basis . . . Previously the road had been making two payments a year . . ."

"Boeing Airplane Co. . . . intends to pay dividends quarterly on or about the 10th of the last month of each quarter . . ."

American Chicle Company, which formerly paid an annual dividend of $2.50 per share, distributed as a $2 regular and a 50¢ extra, furnished an example of the

trend in both respects—it made the $2.50 regular and paid it quarterly.

An analysis of dividends reported in a single issue of a financial paper would seem to be representative of today's trend. Of 77 companies reporting, 21 declared "a dividend" without ascribing it to a particular period, of the rest, 3 were semiannual, and 53 quarterly.

Conversely, the President of the Franklin National Bank reported that of 500 shareholders, 83% favored semiannually rather than quarterly dividends. However, the reference here was to stock dividends, in such small percentages as to create the nuisance of odd and fractional shares.

§ 191. Cash Position.

The fact that a company in the uncertain textile business, like the Pepperell Company, can maintain an unbroken dividend record for over one hundred years, through war and postwar periods, through eras of prosperity and depression, demonstrates that a sound dividend policy can produce results even in a variable industry. Conversely, it may be reasonably concluded that frequently the failure of other companies to maintain a continuous or a regular dividend is due to the lack of a stable and studied dividend policy, to a pay-as-you-go policy.

The principal deterrent to the declaration of a dividend is, of course, lack of earnings. As has been pointed out, where a reserve has been created out of earnings retained in prior years, and an adequate earned surplus exists, lack of earnings for a temporary period, in the absence of indication of future deterioration and

concurrent inability to remedy the condition, does not justify or require reduction or passing of a dividend. Examples are available of companies paying dividends irregularly out of surplus accounts. So we find American President Lines declaring a dividend on common stock for the first time out of "accumulated earnings" and the New York, New Haven and Hartford Railroad Company announcing a dividend on its preferred A stock from "net income surplus."

Of course, even a sound dividend policy will not always protect a regular dividend from drastic unexpected conditions. Labor strikes, flood, fire, shut-downs due to external circumstances beyond expectation or control may defy the best laid plans. Short of these, conditions that affect the cash position are the greatest source of dividend danger. However, such conditions, for example, excessive inventory, slow receivables, or similar items that seriously reduce cash and equivalents, should be of unusual occurrence.

Given a dividend policy and a lack of unusual misfortune, a cash position that will not support a continuance of dividends means that the dividend policy has not been soundly formulated; something somewhere has constituted an unanticipated drain on funds that should be available to maintain a regular dividend. If the cash position has been temporarily drained to build up inventory, not to excess, for anticipated business, or if receivables are unduly slow but safe, on occasion, the directors may be justified in authorizing borrowings for the purpose of maintaining the regular dividends.

§ 192. Management Statements re Dividends.

A matter of frequent concern in connection with pay-

ing, increasing, reducing or passing a dividend is whether or not a public statement should be made in connection therewith, and where one is to be made, its content. While this is really a subject belonging to the field of stockholder relations, it finds discussion in connection with dividend action. The question usually arises when action at variance with established custom is to be taken, when a dividend is to be increased or reduced, omitted, or a stock dividend substituted for or added to a cash dividend.

Basically, the principle that should underlie relations between the management and the shareholders requires full disclosure; a policy of frankness not harmful to the corporate interests should prevail. This phase of the subject is dealt with more fully elsewhere.

Where a dividend is paid that changes existing dividend policy, or a dividend is passed, stockholders should not be left in the dark as to the legitimate reasons for the action. The larger stock exchanges require an announcement at least. Certainly, when a regular dividend rate is being increased, when a policy of declaring extras is to merge into an increased regular dividend, every reason exists for informing the market that it may evaluate the stock at a higher price. Similarly, when directors feel that their essay at paying a minimum rate of dividend has been successful, the dividend should be declared as a "regular dividend" and the board's intention not be left to conjecture. Similarly, when the board finds it necessary to reduce or pass a dividend, its reasons therefor should be stated, so that stockholders and market analysts may evaluate the situation truly. It must be remembered that the human tendency, particularly with the fearful—and that describes the aver-

age investor—is to think the worst, so that the truth cannot be harmful.

§ 193. —— Examples.

The newspaper columns furnish daily guides to varying corporate attitudes respecting terminology:

Resistoflex Corporation: "regular quarterly"; Southern Natural: "a quarterly dividend"; Pacific Mills: "a dividend"; Texas Company: "a regular quarterly"; Commodore Hotel Corporation: "a dividend"; Globe American Corporation: "quarterly dividend."

Examples of statements in connection with declaration of dividends from accumulated surplus appear in preceding pages. Others, casually selected:

Sutherland Paper Company: "The increase in the dividend rate is intended to be permanent."

Collins and Aikman Corporation: "In view of earnings results to date and the desirability of conserving assets for developments ahead, directors took no dividend action."

Motor Products Corporation on reducing dividend: Because of "cut-back in customers schedules and high level of inventories."

Trade Bank and Trust Company on resuming cash dividend payments: "Non-payment was due not to lack of earnings but to the board's desire to increase capital funds . . . it is contemplated a rate of 75¢ a share annually will be continued on the increased stock resulting from the stock dividend."

§ 194. —— Disclosure.

Announcements in connection with dividend declarations are often more informative than management in-

tends them to be. The lack of a sound, long-range dividend policy is frequently demonstrated by statements of management in reducing or passing dividends. And such statements are helpful in a negative way in establishing how a contrary policy would better serve stockholders' dividend interests.

For example:

Vulcan Detinning Company in reducing its first quarter's dividend from 35¢ to 25¢ quarterly stated that the reduction in the dividend was due to a rapid and severe decline in steel scrap prices since "last November" and that this has reduced estimated profit margins for the first quarter "of the year." The reduction was made despite the fact that the company "is in a strong financial position." Manifestly, had the Company created dividend reserves in prior years, dividends would not have had to be tied so closely to current earnings dependent upon so short a period of market deflation.

Seiberling Rubber Company reducing a 25¢ quarterly dividend to 10¢, explained that planned expenditures for a new plastic division, a new tire plant in South America and a planned expansion of the Company's Canadian subsidiary "makes it highly desirable to conserve working capital." It would seem obvious that these were not emergency expansions but items that should have been in contemplation and for which reserves should have been created in prior years, or in any event, should have been the subject of gradual expansion rather than constitute a simultaneous charge upon the stockholders' dividend rights.

The D. L. & W. R. R. making an annual payment of 75¢ after a previous annual payment of 50¢ said this

"reflects a continuing policy" to pay to stockholders as "liberal a share of current earnings as existing conditions and prudent management permit." Here we have a dividend that could be paid quarterly except as it indicates a tie-in with current earnings that disregards any thought of a "policy" designed to produce regular and frequent dividends.

New York Water Service Company announcing its dividends hereafter will be paid on an annual basis, instead of quarterly, said changes in the composition of the corporation and the possibility of further changes made it seem wise to defer dividend payments until the full year's operating results were known, despite the fact that the Company holds $11,268,000 of United States Treasury bills constituting a temporary investment of proceeds from sale of plants to governmental agencies. Why a public utility should not have a reserve out of which it could pay a following year's earnings, regardless of future developments is difficult to understand.

A. F. Frances and Company, investment dealer, sounded out stockholders of Cockshutt Farm Equipment, Limited, on their attitude respecting the reduction of the Company's quarterly dividend to 10¢ from the 25¢ paid since March 1952 and the 20¢ dividend paid prior to that. He pointed out that for the years 1948 through 1953 the Company earned after taxes and had available for distribution to shareholders a total of some $16 million, of which only about $4 million was paid in dividends; that nevertheless because of a possible nonrecurring reduction of profits in one year, dividends were reduced. "If the policy is to be that of modest dividends in good years—

as it has been—such dividends should be steady," Mr. Frances properly said. Certainly, retention of 75% of net income from 1948 through 1953 should have created a reserve from which a 25% dividend could continue to be paid in the absence of catastrophe.

Finally, even E. I. duPont de Nemours and Company, increasing its "interim" dividend to $1, indicated a lack of modern dividend policy concept. A spokesman said that the increased dividend was based on improved earnings and when asked whether the future interim dividend rate would be $1, said that duPont has no set rate for dividends and that they are based on earnings. The dividends paid reflect a unique notion of the need for regularity and frequency since in the last three years, the Company had paid "interim" dividends of 85¢ a share supplemented with year end payments which were $1 a share in 1951 and 1952 and $1.25 a share in 1953. In 1950, a total of $5.35 a share was distributed to stockholders. One wonders how labor would react if it was subjected to such uncertainties for its wages; yet the stockholder's investment is quite as constant and the need for certainty of income may be, at least with some, quite as great.

§ 195. Certification Preceding Dividend Action.

As noted elsewhere, directors are personally liable to the corporation and its creditors for dividends unlawfully paid. However when they act in good faith, the law protects them.

There are two general classifications of restrictions against the payment of dividends, the first, those imposed by the law to protect the corporation, its credi-

tors and stockholders, the second, those imposed by private contract. The first class of restrictions we discuss elsewhere, the second are those which are frequently imposed by lenders and which appear in bank loan agreements and indentures securing or evidencing debt securities issued by the corporation. Issues of prior classes of stock invariably restrict dividends on the common stock while preferred dividends are in default; various classifications of stock may apportion or restrict dividends (see Part II).

Here, we are concerned with the practical not the legal aspects of the director's job. Since the law gives the director protection in declaring dividends when he acts prudently, and particularly when he relies upon the certifications of accountants and other corporate officials charged with knowledge of the necessary details which legally justify or do not justify the declaration of a dividend, a director should insist upon prior certification by a proper and responsible official of the facts that should control. Generally speaking, this requires certification of restrictions, if any, upon the payment of the particular dividend under consideration, and the necessary figures to demonstrate that they are not being violated. In practice, a short form of certificate by the treasurer or the corporation's certified public accountant will suffice. This is a proper precaution every corporation should take for the protection of itself, its directors, its creditors and stockholders.

§ 196. Record Date.

It is customary to declare a dividend and make it payable to stockholders of record as of the close of business on a specified day, payable on a subsequent date. This

has generally susperseded the old practice of closing the transfer books of the corporation for a period preceding the date the dividend is payable. The rules of various stock exchanges prescribes the interval between the record and the payment dates.

§ 197. Preferred Stock Dividends.

§ 198. —— Generally.

As we point out in Part II, the rights of preferred stockholders depend upon the provisions pursuant to which the stock was issued. Consequently, the discretion of directors in declaring preferred stock dividends is circumscribed by the contract and the subject becomes largely legal in its nature and directors must rely on company counsel in dealing with preferred stock and preferred stockholders.

However, it may be noted here that it is for the directors to determine when there are earnings and/or surplus available for the payment of preferred dividends. However, the rule that wide discretion is vested in directors, the concurrent unwillingness of the courts to interfere with the exercise of that discretion in declaring common stock dividends lacks application in the case of preferred stock dividends, and the courts will be found less loath to enforce the contractual rights of the preferred shareholders to dividends.

Generally, however, these are matters for company counsel's advice, rather than matters concerning which directors require aptitude so that they may act with sound judgment. In the case of preferred stock, ordinarily directors are concerned only with ability to pay the stipulated rate at the times called for and are not

concerned with the various matters discussed in connection with common dividends.

§ 199. —— Need of Paying Preferred Dividends.

Aside from the legal implications of their contract, the preferred stockholders' right to dividends is entitled to the highest measure of respect by directors. It is to be remembered that directors represent and have fiduciary obligations to all shareholders, though they may be elected by one class or another. Beyond that, the corporate standing in the stock market is seriously impaired when preferred dividends are in default.

§ 199a. Unfairness to Common.

In given situations, the failure to pay preferred stock dividends may be unfair not only to the preferred shareholders but also to the common stockholders. The impairment of the credit and standing resulting from preferred dividend defaults works to the corporate and therefore the common stockholders' disadvantage.

Ordinarily, while default exists in payment of preferred dividends, common dividends may not be paid. Frequently, failure to pay preferred dividends for a given period entitles preferred shareholders to elect a majority of the board. The SEC advocates such practice for utility companies under its jurisdiction.

Where default in preferred dividends works a change in control of the corporation by entitling the preferred shareholders to elect a majority of the board, failure to pay preferred dividends is doubly detrimental to the common stockholders.

§ 199b. Unfairness to Preferred.

On occasion, the deprivation of dividends to preferred shareholders may be of great advantage to common shareholders and correspondingly unfair to preferred shareholders. The extremes of this consequence are found in reorganization proceedings where, though the common stock equity had become practically nonexistent, by use of earnings withheld from the preferred shareholders, under the protection of the reorganization tribunal, ultimately a common stock equity was revived, since the preferred, when they ultimately received the dividends in default, did not receive interest thereon, to say nothing of the added increment that had been earned by the use of their withheld funds.

To a lesser degree, when no penalty attaches for failure to pay preferred dividends, common stockholders have benefited by this practice in going concerns. This is one of the prime reasons and necessities for assuring preferred shareholders control when preferred dividends are in default.

Where provisions for preferred stock control in the event of default are to be found, numerous devices and chicaneries are practiced by common stock managements to avoid the prescribed penalties. For example, there is the case of one common stock management that has paid one quarter's preferred dividend each year to avoid the prescribed "four consecutive defaults." Purchase of preferred stock by common stock management in order to acquire preferred stock votes to defeat the preferred stock control provision is another such device.

Manifestly, directors violate their fiduciary obligations when they lend themselves to such ruses.

§ 200. Stock Dividends.

§ 201. —— Defined—Difference between Stock Dividend and Stock Split.

A stock dividend—the issuance as a dividend of stock of the company which declares the dividend—is the means of retaining and reinvesting earnings which would otherwise go to stockholders as dividends. In accounting effect, it is a transfer and reduction of earned surplus to and a corresponding increase of capital represented by stock. Herein it is distinguishable from a "stock split" which is simply a reallocation of stock without change of total capitalization. Let us illustrate by an example of a corporation that simultaneously split its stock and declared a stock dividend.

Stockholders of the Kings County Trust Company, with an outstanding capital stock of 5000 shares of the par value of $100 per share (total capitalization $500,000) approved a two and one-half-for-one split of the stock, thus entitling each holder of one $100 share to 2½ new shares, each of the par value of $40. Thus there was no change in the previous capitalization, which remained at $500,000 which now, instead of being represented by 5000 shares of the par value of $100 each, was represented by 12,500 shares of the par value of $40 per share. Thereupon, giving effect to the stock split, the directors declared and the stockholders approved a 300% stock dividend on the newly authorized stock, so that each stockholder entitled to 2½ $40 shares for his original $100 share became entitled to a further 7½ $40 shares, or a total of 10 shares of new $40 stock for each original $100 share. Thus the new capitalization, following the stock dividend, was increased from

$500,000 to $2,000,000, now represented by 50,000 shares of the par value of $40. Accounting-wise, the $1,500,000 increasing the capital came from earned surplus, which was reduced accordingly.

Thus is illustrated the basic difference between the stock split and the stock dividend; in effect the latter transferred to stockholders' account $1,500,000 of accrued earnings but in lieu of paying it to them in cash, in effect took it back as an investment represented by the capital stock which it issued to the stockholders as a stock dividend.

In some quarters, a "stock split" of 25% or less is deemed a "stock dividend."

A further distinction may also be noted—that while the stock dividend lies wholly within the discretion of the directors, the stock split requires stockholder approval.

§ 201a. Neither Taxable.

It is to be noted that neither transaction illustrated above subjected the stockholders to income taxes which would have been chargeable had the dividend been paid in cash since in effect and substance the stockholders received no cash distribution; their investment in the corporation remained in the same amount it had been formerly, except that now the equity was represented by a larger capital and a lesser surplus account.

§ 202. —— When a Stock Dividend Is Properly Declared.

It thus becomes apparent that in order to properly declare a stock dividend and thereby increase the outstanding stock, there should be funds or assets which

constitute surplus which otherwise would be legally available to the payment of an equivalent cash dividend. A further standard should be noted, an ethical rather than a legal one, the corporation should have a reasonable expectation of paying dividends at the existing rate on the additional stock issued. The fairness of this standard becomes apparent when we repeat what we said previously, that in effect the stock dividend is a simultaneous disbursement to the stockholder and a reinvestment of the disbursement by him in stock of the corporation. Obviously, a corporation should not seek or take additional capital unless it expects to be able to pay the stockholder an adequate return thereon; and in such case the existing rate may be said to define an "adequate return."

It is true, of course, that whether a corporation carries its assets in a surplus or capital account, they are being employed in its business—and equally gainfully regardless of the accounting niche. But that is not the salient point here. The relevance in this context is that when the surplus is transferred to capital and the stockholder is given an equivalent stock certificate as a dividend, he is being told that the cash which he might have received as a dividend but which, instead was withheld, was so reinvested for his account that it can now be expected to pay him a return. That is the representation implicit in the declaration of a stock dividend.

Where, however, the unusual purpose of a stock dividend is merely to effect the primary purpose of a stock split, i. e., to increase the total number of shares outstanding, as is pointed out later, the corporation may be justified in declaring such a stock dividend without

intending to continue the existing rate of dividend on the added stock so issued.

Where a corporation is desirous of paying out a fair percentage of its earnings and yet is desirous of retaining for expansion purposes surplus than would be unavailable if dividends were paid, the stock dividend serves a useful current purpose. And where the surplus earning account is swollen beyond current operational needs, but the cash can be gainfully employed for expansion, the stock dividend is a useful means of supplementing the ordinary cash disbursement, with tax benefit to the recipient, as indicated, plus the opportunity to realize upon part of the original investment, upon a capital gain basis.

Generally, it may be said that where there is a tug between directors' desire to retain earnings and to pay dividends and where the retention of earnings may reasonably be expected to produce added income and the corporation is in a cash position to anticipate such added income by present dividends on the added stock, the stock dividend will serve a useful and necessary purpose, particularly if it is accompanied by a clarifying statement to stockholders. The previous example of the Dow Chemical Company furnishes an excellent example of the proper stock dividend route.

Of course one might say: What difference does it make? The investment is in the corporation and whether it is in earned surplus or capital, it still belongs to the stockholder and lends value to his stock. Academically, the answer is that it is so, but practically, since market value is largely measured by dividends, the stockholder receiving stock dividends for his withheld cash dividends has a more valuable investment

marketwise and can realize more for it than can the stockholder whose directors are not so alert to his interests. At the same time, it is to be noted that ordinarily the market evaluates a stock paying cash dividends at a higher rate than it does a stock paying stock dividends, although to the high bracket investor the latter may be of greater value than the former.

It may also be added that where there exists an area of conflict on the board—where, for example, a management wants to make charge-offs for business and tax purposes, though they may not represent true loss, as is sometimes the case with inventory or fast depreciation (see previous discussion), agreement on a corresponding stock dividend may be a valuable medium for compromise.

While a corporation may properly substitute a stock dividend for a cash dividend or supplement a cash dividend with a stock dividend, there should be good reason for substituting stock for cash and the practice should not be allowed to become a regular one except for compelling reasons.

There are, however, times when a stock dividend is called for and numerous cases where directors have been lax in making such distributions. Examples are found of railroads which pay out only a small percentage of current earnings as cash dividends, reinvesting the balance in capital improvements. Here, the stockholders would appear to be entitled to stock dividends representing at least a portion of the retained earnings, the portion so represented being measured by the earning capacity of the amounts reinvested. In other words, if a corporation should not issue stock as a dividend unless it has a reasonable expectation of paying normal

dividends thereon, then, conversely, by the same token, when it reinvests for capital purposes earnings which otherwise should go to stockholders as cash dividends, the stockholders should have such additional future earnings (which constitute the usufruct of what should have been their cash dividends) as dividends on additional stock.

§ 202a. Examples.

Plastic Wire and Cable Corporation voted the regular dividend of 15¢ and declared a stock dividend of 10%.

Vanadium-Alloy Steel Company declared a dividend of 10¢ and a 1% stock dividend. The Company said the cash and stock dividend amounted to 63¢ compared with 65¢ paid in the three previous quarters. It said the method of payment was made to conserve cash and did not reflect lower earnings. It also said the board had not yet decided on whether to continue the dividend payments on that basis.

Tidewater Associated Oil Company sought to mediate between its stockholders who wanted cash dividends and those who preferred stock dividends by creating a preferred stock with cash dividends and offering common stockholders opportunity to exchange therefor and thereafter declaring stock dividends on its common.

In line with this expedient, a corporation might create an "A" stock with all the rights and privileges of common and exchangeable into common at any time, on which the directors would declare stock dividends as an equivalent, on a basis of existing market prices, of declared cash dividends on the common stock. "A" stockholders would have their cash dividends reinvested

for them without tax deduction if the Revenue Department shares the writer's opinion that the convertibility of the A stock does not give the A shareholder an election between cash and stock dividends; the contrary conclusion would destroy the nontaxability of the "A" stock dividend.

Citizens Utilities Company, which had had a policy of combined cash and stock dividends, announced its purpose of continuing it for 1955. The president said that, in response to a questionnaire, of 70% of the stockholders, 55% favored stock, 8% cash and 38% the cash-stock combination. He said that the management was studying a plan whereby each stockholder might get the type of dividend he preferred.

§ 202a1. Dividends on New Stock.

Lily Tulip Cup voted a 50% stock dividend on common increasing outstanding common from 449,306 to 673,959. It announced that the previous quarterly dividend of 62½¢ would be superseded by a 60¢ rate, equivalent to 90¢ on the old stock.

Trade Bank and Trust Company declared a 10% stock dividend and announced that it was expected that the existing 75¢ per annum rate would be continued on the increased stock.

Firemens Fund Insurance Company announced a 20% stock dividend and an increase in the annual rate of cash dividends to $1.80 a share from $1.60 and pointed out that the stock dividend and increase in the cash rate will mean an increase in dividend income of 35%.

§ 203. —— When a Stock Dividend Is Improperly Declared.

A corporation lacking earnings or earned surplus available to pay current dividends frequently resorts to declaring stock dividends, in order to placate stockholders, or for some other ulterior purpose. Such a practice lacks justification.

Indeed, the New York Stock Exchange has a rule (which it recently enforced as against the International Business Machines, a highly respectable and prosperous corporation) that prohibits a stock dividend or stock split less than 25%, the market value of which, with cash dividends declared in a single year, exceeds the annual earnings of the corporation for that period.

To illustrate: IBM announced that owing to the policy of the Exchange it would distribute only a 2½% stock dividend rather than its usual 5%. If IBM had paid the usual 5% stock dividend (which would have had a fair market value of approximately $12.50) plus the annual cash dividend of $4, or a total of $16.50, the aggregate would have exceeded the estimated annual earnings of IBM of $10.50 to $11 per share.

While the purpose of the Exchange is salutary, and in general application will serve to protect stockholders, the application of this rather stringent standard might be challenged in the case of a corporation such as IBM which has a large earned surplus, since there should be no more objection to paying a stock dividend to represent surplus earned and reserved in prior years than there would be to paying a cash dividend not currently earned, from that source. That, as we have pointed out, is one of the functions of reserves, i. e., to stabilize and regularize dividends.

§ 204. —— Scrip for Fractional Shares.

When a stock dividend is declared payable on a less than share-for-share basis, stockholders holding odd or an insufficient number of shares will become entitled to receive fractional shares. In order to avoid complications, in lieu of issuing fractional shares, or of paying cash in lieu of fractional shares, scrip may be issued evidencing the stockholders' right to the fractional shares so that these may be bought or sold and full shares thereby accumulated and the scrip exchanged by the corporation or its transfer agent therefor. Added provisions for the protection of the shareholder and the corporation usually fix a date upon which the corporation can sell the full shares represented by unexchanged scrip and distribute the fractional cash proceeds to the unexchanged scrip holders. Where a practice of stock dividends is continued, the fractional share scrip usually accumulates in the hands of the respective shareholders so that exchange for full shares can be made by the shareholder periodically.

Example: Pittsburg Steel Company paying a stock dividend of 2% announced no fractional shares would be issued; in lieu of scrip, as formerly, the company would sell the equivalent common stock and distribute the cash pro rata.

§ 205. —— Preferred Stock as Dividend.

Though it is unusual to do so, a corporation may, in lieu of a cash or stock dividend, pay dividends in the form of its bonds, notes or preferred stock. More usual than debt securities is the distribution of its own preferred stock as a dividend. As in the case of a common

stock dividend, this has the effect of transferring earned surplus represented by the preferred stock distributed, to capital. When a preferred stock issue is created solely for the purpose of paying a dividend, generally, the preferred stock dividend is not subject to tax in the hands of the recipient; the general rule is to the contrary as to preferred stock previously authorized and issued, though, as with all tax questions, caution must be exercised and tax advice obtained.

Here, manifestly, the principle of not issuing stock as dividends without an intention to pay added dividends thereon finds confirmation in the ordinary preferred pledge to pay dividends.

Example: Hancock Oil Company initiated a plan for distribution of 200,000 or more shares of a new 5% preferred stock to holders of outstanding A and B common stock at the rate of 1 share of the preferred for each 16 shares of common. As a result capital was increased by transfer from surplus of $25 for each share of the new preferred stock issued.

§ 206. —— Stock of Other Corporations as Dividends.

A form of stock dividend not infrequently met is the payment of a dividend in the stock of another corporation, usually a wholly or partly owned subsidiary. This may be what is commonly termed a "spin-off." This is the device of putting part of the corporate assets in a subsidiary and distributing the stock of the latter pro rata to the corporate stockholders. This device is sometimes resorted to under legal pressures; to avoid or settle antitrust litigation is probably the most frequent example. So years ago, the railroads divested themselves of their coal interests, the Standard Oil Compa-

nies divested themselves of their alleged monopolistic controls. It has been resorted to in recent years by natural gas companies which sought to avoid price regulation for field gas. In more recent years, as one of many possible examples, Southern Natural spun off Southern Production.

Companies, such as Electric Bond and Share, declare dividends in shares of stock of other companies which they own and may not keep when qualifying to become investment companies.

§ 207. Issuance of Rights to Subscribe.

A stock dividend, as indicated, is the declaration of a dividend payable in stock. The stockholder is not called upon to pay anything for the new stock. However, it is possible, in effect, to declare a partial stock dividend by giving stockholders the right to subscribe for additional stock at a price below its market and book value. It is customary practice when added capital is sought to issue rights to stockholders to subscribe to the new stock to be issued. In fact, under many existing state laws, this is necessary since stockholders have prior —"pre-emptive"—rights to subscribe to additional stock so that they may protect their proportionate interests in the corporate equity from being diluted.

Aside from pre-emptive right requirements, it has been found expedient and profitable by successful managements with good stockholder relations to let their stockholders in on the ground floor when building additions to their financial structures. Accordingly, it has become successful practice—particularly with utilities—to offer rights to existing stockholders to subscribe for the new stock at a price that shades somewhat usually

about 10% the existing market price. Those stockholders who do not exercise their rights to subscribe, are usually able to sell their rights at a price which varies proportionately with the differential between the offering and the market price of the stock.

This differential received by the stockholder, though not technically deemed a dividend, is obviously in the nature of a stock dividend, since it is the proceeds of a right—a warrant—issued to the stockholder as an incident of his stockholding. Similarly, the stockholder who exercises his right to subscribe is receiving a share of stock for a consideration less than a stranger need pay—in a word, he is in effect and substance getting a fractional stock dividend. The conclusions in both cases become more clearly defined if one assumed a stock selling at $10 in the market and a right issued to stockholders to subscribe at $5 per share, or to exaggerate to make the point—$2. The right to subscribe, saleable at $8, would in effect be an $8 cash distribution to the stockholder who sold his rights; a subscribing stockholder would, in effect, be paying $2 for 1/5th of a share of stock and getting a stock dividend of 4/5ths as a distribution.

An outstanding example of common stock financing by issuance of rights to subscribe was furnished by General Motors which offered over 4¼ million shares to its stockholders—the largest underwritten corporate security offering in history—at the rate of 1 new share for each 20 held at a price approximately $25 under the market. Another noteworthy feature of this gargantuan operation was found in the decision of the du-Pont Company to exercise its rights to subscribe for a million shares.

§ 208. Stock Splits.

§ 209. —— Defined.

In differentiating between stock dividends and stock splits, we illustrated by the example of the Kings County Trust Company which reduced the par value of its authorized stock, i. e., split it from $100 par to $40 par, entitling holders to 2½ shares of $40 par stock for each single $100 par share previously held. This stock split left the aggregate corporate capital just where it has been—at $500,000—5000 shares of $100 par translated into 12500 shares of the new $40 par stock.

While basically the stock split is merely a legal and accounting matter, and merely divides the corporate capital into a larger number of smaller parts, in practice it may serve useful purposes of benefit to the corporation and its stockholders.

§ 210. —— Purpose.

§ 210a. Broadening Market.

Ordinarily, the primary purpose of a stock split is to bring the market price of the stock to reasonable proportions and thereby broaden its market. For an example, we have the Kings County stock, which before the split was selling at $1600 per share. Manifestly, such a market price limits severely the number of investors who can or will buy the stock and in effect impairs the market for the stock, with consequent lessening of bids and loss for a prospective seller. It also tends to restrict the number of shareholders and minimizes public interest in the stock. In short, it works the converse of what enlightened management seeks to promote through a wide and active market for its stock. The latter is

accomplished by splitting the stock so that its per share price will approximate a level that increases its potential investors.

A survey made by the Los Angeles Stock Exchange indicated that of 1375 answers received from 5800 shareholders in 8 corporations, 804 felt that $20 to $35 per share represented an ideal price range; 53 preferred stock with a market price of $5 or less.

It is common knowledge about the Street that stocks with low market values find more ready buyers; really low priced stocks are attractive because of the large percentage of gain accruing from a small increase in price. Of course, this does not justify extremes; "penny" stocks lend nothing to the credit or standing of a corporation. As extraordinary high market prices connote a stuffiness about a corporate management, so extremely low prices carry with them an aura of cheapness.

Many corporations with steady growth make it a practice to split their stock periodically as their market prices rise above 100.

In a bull market stock splits become numerous. The New York Stock Exchange reported 23 stock issues split 2 for 1 or better in 1953, versus 34 in 1954, compared with 35 in 1952, 49 in 1951, 33 in 1950 and 17 in 1949. In 1946 there were 74. The decline in 1953 split ups was attributed to the 1953 market decline.

A 1955 survey made by the New York Times led it to conclude that a stock split by itself increased shareholders only in the smaller companies; that American Telephone and Telegraph, without stock splits, had had a "phenomenal" shareholder increase, while other large companies that had split their stock, like General Motors, had had smaller and only temporary increases.

§ 210b. Reducing Per Share Earnings.

The second primary reason for stock splits is the less tangible one of diminishing per share earnings or at least not increasing dividends to a point that will awaken resentments, create excessive labor demands, encourage tax increases or rate reductions, and the like.

When stock is split for such purpose, dividends will be less per share. When the split is for the purpose of avoiding increasing per share dividends to amounts which may stimulate the type of trouble to which we have adverted, the split may be accompanied by increase of the reduced per share dividends, thus effecting the purpose of increasing the former aggregate without incitement to feared detriment.

§ 211. —— Examples.

Superior Portland Cement Company split its stock 2 for 1 and fixed the subsequent per share quarterly dividend at 15¢, half the former 30¢ rate. Canada Steamship Lines, following a 4 for 1 split, indicated the rate on the new common would be "at least as much" as the rate on the old, a prospective 25¢ per annum versus the former $1.00. Also, since the preferred was split on the same basis, the new dividend rate was indicated at 62½¢ against the former $2.50. (This of course would necessarily follow, in the case of a fixed dividend preferred stock; by an increase, the rights of the common shareholders would be violated, while a reduction would infringe the contractual rights of the preferred shareholders.)

On the other hand, Sheraton Corporation management, recommending a 2 for 1 split, declared its inten-

tion of increasing the new dividend rate by 33⅓%, putting the new stock on a 40¢ basis as against the previous 60¢ aggregate.

An extreme instance of a stock split is found in the 500 for 1 split announced by the San Francisco Bank with a projected quarterly dividend of 45¢ (an annual rate of $1.80 aggregating $900 per annum for the old stock as against the prevailing $800 rate). Here, one wonders why the management was not moved to split the stock before its market value and dividend rate reached such rarefied heights.

§ 212. —— Market Price Increase.

Though stock splits may leave the corporate dividend rate undisturbed, they are taken generally as a mark of a growing and profitable enterprise. Consequently they find favor market wise and the prospect of a stock split invariably has at least a temporary bullish market effect.

In part, at least, because of the fact that experience demonstrates these market rises in contemplation of stock splits justified, either immediately or ultimately, the old stock market adage of two pieces of paper being worth more than one finds immediate credence in stock splits. However, unless substance is given to the stock split in the form of prospect of increased earnings or dividends, it will lose some of its market appeal and except for the better market produced by the more reasonable price range, no permanent market effect may result. However, where conditions warrant, directors are justified—indeed, they promote stockholder good will by splitting stock.

§ 213. Liquidating Dividends.

§ 214. —— Capital Distributions.

A corporation that lacks net current earnings from which to pay dividends may nevertheless have or accumulate cash from depreciation, sale of capital assets, etc. If the business of the corporation does not warrant the use of these funds, the directors may seek other sources of profitable reinvestment. (In this connection it may be noted that fairness prompts an opportunity for stockholders to determine whether their funds should be reinvested in sources afield from the purpose which they contemplated in buying their stock, that dissenters should have opportunity to withdraw. However this latter problem is solved when a fair market exists for the stock and dissenters can sell at fair prices.)

In the absence of such a reinvestment policy, directors should not retain sterile excess working capital. Instead they should return it to the stockholders so they themselves may invest it profitably, by declaring "liquidating dividends." These may be accompanied by formal reduction of corporate capital, in proper cases.

A noteworthy example of this was found when Montreal Locomotive Works declared a special dividend of $9 with the statement that its working capital had been substantially in excess of its operating needs for sometime and that the management believed its stockholders could reinvest the money to better advantage than could the company. The exceptional situation lay in the fact that American Locomotive Company held 4/7 of the outstanding stock and could use its cash distribution for its own corporate purposes. Incidentally, there was a division of opinion on the board

as to the justification for the distribution; two members resigned.

In essence, such a procedure constitutes a partial liquidation. When a corporation intends to or does dissolve, it distributes its net assets to its stockholders similarly, by liquidating dividends, which, properly speaking, are not "dividends" but capital distributions.

To illustrate capital distribution, as opposed to distribution of earnings:

A large utility company owned a considerable portfolio of securities for which it had no particular need. Had they been sold in the ordinary course and the proceeds of sale, not required by the corporation for capital purposes, been distributed in the ordinary way, the corporation would have paid a capital gains tax and the stockholders would have been subjected to normal income taxes on the proceeds received by them as dividends. Instead, the securities were distributed in kind to stockholders as return of capital.

Recent years have witnessed many examples of utility holding companies being liquidated under the compulsions of the Utility Holding Company Act administered by the Securities and Exchange Commission. In these cases, their assets, consisting largely of the control stocks of utility operating companies, were distributed in kind, tax-free, to the holding company stockholders and the holding company was dissolved. In other cases, the holding company was permitted to continue its existence and ownership of some of its operating companies. Here there was no dissolution of the holding company but what did result was a partial liquidation, by distribution of some of its operating company stocks to its stockholders. Here too, the dividends were

liquidating dividends, capital distributions and, in consequence, tax-free. It might be noted that such distributions do not constitute tax precedents for ordinary liquidation or dissolution, since special revenue statutes (Supplement R so called) were applicable to these compulsory utility liquidations.

A recent example of liquidating dividends was furnished in the case of the Reo Holding Company which having sold its assets to Bohn Aluminum and Brass Corporation undertook to distribute the 16½ million of cash proceeds and dissolve. A group of stockholders headed by the TelAutograph Company opposed dissolution; they elected a slate of directors committed to complete distribution of all but a final dollar a share and thereafter, with the reduced capital, to acquire another company, Nuclear Consultants, and continue business.

§ 215. Stock Repurchases.

Partial liquidation sometimes takes the form of repurchasing previously issued and outstanding stock in lieu of making capital distributions to stockholders. This, in effect, reduces the outstanding capitalization, though it does not do so formally unless the bought-in stock is retired. It has the practical effect, if stock is bought in at less than book value, of benefitting stockholders who remain by increasing the book value of the stock still outstanding.

It may be noted that in repurchasing stock, directors have a fiduciary obligation to all the stockholders, sellers as well as buyers; they should not therefore attempt to overreach those who may be willing to sell by fixing an unduly low price or by nondisclosure of the corporate

purpose. On the contrary, the price fixed should bear a reasonable relationship (on a discount basis) to fairly realizable book value and must necessarily take into consideration the existing market price.

§ 216. Tenders.

One method of repurchasing stock is to invite tenders from stockholders who desire to sell their stock. The invitation usually fixes a maximum amount of stock that will be taken and a maximum price and offers are accepted at the lowest prices, with proportionate acceptance to avoid exceeding the maximum. This method was successfully employed when the new management of Butler Brothers liquidated some of its operations and found itself with working capital in excess of its needs.

CHAPTER XIII

Exercise of Functions—Stockholder Relations

§ 217. Defined.

Stockholder relations may be defined by synonyms—stockholder good will, satisfaction, pride, or conversely, dissatisfaction, suspicion, or annoyance.

Were the directors selected by the stockholders, stockholders' relations, good or bad, would be evidenced by the relations between the management and the directors. But since the fact is that directors are usually the selectees of the management in power, their point of view and attitude are ordinarily more representative of operating management's than of the stockholders, so that "stockholder relations" are expressed in terms of the stockholders' estimate of management, executives and directors alike.

§ 218. Importance.

There is growing management recognition of the value of good stockholder relations. The day of the

close-to-the-vest management, secretive, making little or no disclosure to stockholders it considers necessary nuisances is passing. The revolt of the masses includes growing stockholder consciousness. This has tended to a demand for more widespread democracy in the corporate world. Here the tendency has been stimulated by the large increase in the number of small shareholders, all of whom are potential consumers and customers, with the result that we find closer identity between stockholder, consumer and public relations. The newspaper publicity attendant upon annual meetings and proxy contests and the transfer of many of these news reports from the financial to the general reader pages attests the greater general interest in these matters and stimulates stockholder interest and activity.

It can fairly be said that the support of stockholders and their cooperation with and confidence in management tends to promote the business of the corporation, to broaden the markets for its products, to build consumer good will, to advance the credit and standing of the company, to provide sources of new financing, to make for better and stable markets for the purchase and sale of the company's stock and to generally promote the general welfare of the company and its management.

§ 219. Management Recognition.

No management today will deny the corporate need of good consumer and public relations. Even the head of the steelworker's union is quoted as saying, not only management but employees must "give full consideration to . . . stockholders." Yet, in the past, many have failed to give sufficient heed to the fact that the stockholder is the public and may be the customer or

consumer, or if he is not, may be a direct word-of-mouth medium, more potent than the lip service of hired pitchmen, to promote the sale of the company's products.

Today, no oil company selling trade-marked gasoline at service stations, no drug manufacturer, no manufacturer of household products, of food, no chain store, to mention only a few of many, can fail to recognize the stockholder in the person of a consumer and a promotor of its wares. Every resident stockholder of a utility is a consumer. General Motors with its many stockholders has a potential car owner in every shareholder. And when the Buick automobile advertising directed the prospect "to ask the man who owns one," it evidenced recognition of the fact that ownership is an advertising medium.

Flourishing retail cooperatives in many parts of the country today demonstrate the value of the consumer-stockholder. Likewise, if employees are stockholders in a prosperous concern, there is a natural sense of proprietorship incentive that is frequently reflected in the daily work output.

So we find the chairman of the board of the Socony-Vacuum Oil Company talking at the annual meeting of the need for making friends of the company and saying "what people think of a corporation has a lot to do with its success or failure in making money."

And we find Eugene Grace, chairman of the board of Bethlehem Steel Company saying on the occasion of a stock split up: "The more stockholders we get in the institution, the better it is for the institution."

The validity of the Grace observation is found in the efforts referred to in a previous chapter to increase and broaden stock ownership, the New York Stock Ex-

change budget plan, for example, and the effort of the utilities to place their stock in their respective territories. Obviously, if consumers are stockholders and profit by the relationship, there is greater tolerance for what otherwise might be considered utility community nuisances.

§ 220. Allocation of Functions.

The keystone of stockholder satisfaction, the production of profit, is, of course, in the keeping of operating management. The allocation of net income to dividends (one of the main sources of stockholder satisfaction) is for the board. The maintenance of a stable market in the corporate stock is a consequence of profits, dividends and financial policies, to which both management and the board contribute. The maintenance of good will through contact might be described as an overall job for the participation of every member of the organization. The telephone girl who tells the customer Mr. Blank is busy and then goes off the line and lets the customer hang in mid-air with a dead wire can probably do more to injure company good will than an advertising appropriation can do to gain it.

The executives will prepare reports; the directors will pass on them. The executives will call and prepare for meetings; directors will attend and participate in them.

Thus, it may properly be said that since the function of creating and maintaining good stockholder relations reaches into many phases of the policy and administrative sides of corporate life, it is a joint one for the board and every member of the operating organization, executives and employees alike.

§ 221. —— Director as Liaison Agent.

In dealing with stockholders, director-stockholders can frequently be more effective than the executives themselves. Directors who have stock market and brokerage contacts can be a medium for keeping the street permissibly informed. Directors in cities remote from the company's offices can be a medium for stockholder and investor contact. Directors can explain to inquiring stockholders the background of results and reports and make them more intelligible. They can effectively supplement management's efforts at an annual meeting. They frequently will command stockholder support for management and are in a better position to answer unjustified and uncomprehending stockholder criticism.

Likewise, they can serve as a conduit to keep management informed of stockholder opinion and reaction and thus enable management to avoid making mistakes in its dealings with stockholders. An experienced stockholder-director will speak the language of stockholders and of the financial pundits better than operating management can; he will have a better appreciation of how stockholders think and feel.

A director, so qualified, will not only perform his share of the board's exercise of this function, he will participate in its execution.

§ 222. —— Director as Supervisor.

It must be remembered that in his capacity of the representative of the stockholders, the director has functions which entail responsibilities he should not delegate. The trusteeship relationship of the director flows from the trust vested in him as the agent of the stockholder.

While the good or bad will relationship between the stockholder and the corporation and its management carries with it no financial responsibilities, the director's legal relationship to the stockholder carries with it at least a strong moral obligation to see to it that the stockholder is fairly treated.

It does not do for a director to shirk this duty and leave the subject of stockholder relations wholly to operating management.

A director must realize that, whether consciously or not, the loyalties of members of operating management may differ from those of the board members. Operating management's primary purpose may merely be to keep the enterprise going and thereby provide salaries, pensions and bonuses for its members. Many executives can be found going along contentedly for years in control of nondividend paying enterprises. Top executives of large corporations usually own small amounts of stock; little of their incentive comes from dividends. So, too, with subordinate employees whose main interest lies in keeping their jobs and continuing their salaries.

Of course, executive officers would rather have satisfied than dissatisfied stockholders; although some would rather have none at all. These consider dividend demands a nuisance that merely complicate corporate life. This does not mean that these executives are not interested in heading a successful rather than an unsuccessful organization. But there is a vast difference between making profits and paying them out. There are many corporate conservation and expansion reasons for the slip between the cup of profit making and the lip of dividend declaration.

Primarily, nonstockholding management is more in-

terested in keeping stockholders quiet than it is in keeping them happy. On the other hand, the director's job is to keep them affluent. The director's basic loyalty is to the stockholders. Operating management contains whirlpools of cross-currents of loyalties, loyalties to one another, to the continuance of the organization, to jobs, unions, salaries, and frequently to the community.

Daily we have been hearing that a board of directors has decided to close down its profitless Massachusetts-town textile mill. Who could expect local management to do this, and, in effect, close down the town supported by its payroll and taxes? With the issue thus drawn between survival of employees and their community and whether corporate profits elsewhere should carry the local loss, what local management could be expected to vote for liquidation? How many managements could be expected to vote to liquidate and distribute millions of dollars of capital and surplus to stockholders as a liquidating dividend, rather than to permit the enterprise to continue and pay the capital and surplus out in salaries and losses as long as they lasted?

The answer is obvious, and the board's self-protection, as well as its devotion to its stewardship, requires that it and not operating management furnish the balance and the answers to these and innumerable other financial questions that lie at the base of stockholder, employee and community relations.

But we are not to be understood as limiting directors' supervision or control to financial matters affecting the stockholder relationship. As we indicated at the beginning, the duty goes beyond that; it requires supervision of every phase of management's attitude and acts

that go to further or depreciate the stockholder relationship.

§ 223. Bases—Generally.

Since the primary purpose of the stockholder is profit, the first and most stable assurance of stockholder satisfaction lies in stability or appreciation of capital investment and regular and liberal dividends.

Competent operating management is not always a wholly satisfactory management. It may be a management addicted to niggardly dividends. It may be a management that disregards the effect of its policies or lack of policy on the stock market in its stock.

Stockholder good will can be enhanced by devotion to financial policies that will furnish stockholders with a stable market in which they can sell their stock at its fair value. Stockholder satisfaction calls for management competent in both operations and financial practices. One without the other will not suffice.

Also, even the effect of lavish gifts can be spoiled by the grudging or patronizing attitude of the donor. So the material effect of successful management can be colored by a dictatorial, an unapproachable, a secretive or resentful management attitude—and many "correct" and otherwise "impeccable" managements combine these invidious corporate traits.

Adherence to "correctness" may only mean "brush-offs" in personal contacts with stockholders, secretive and evasive replies to their written inquiries. It may include overconservatism in making disclosure equivalent to secretiveness, and lagging disclosure of information breeding suspicion that the "insiders" first want an opportunity to capitalize on it. It may result in un-

willingness to disclose good news for fear of causing speculation in the stock and suppression or alleviation of bad news to prevent adverse stock movements. Such a paternalism may discourage attendance of stockholders at meetings and be tolerant of setting them at times —eves of holidays—and places inconvenient to stockholders, of giving little or no information when soliciting proxies, of disregarding stockholders' tax problems. In all such matters a management may be guilty of a host of major and minor faults, the negatives of positives we enumerate hereafter to breed good stockholder relations, all symptomatic of an aloof and uncooperative management that, despite operating success, will have poor stockholder relations.

In antithesis to the foregoing narration of contributions by a "correct" management to poor stockholder relations, we find competent management building the foundations of good stockholder relations in a myriad of small ways designed to establish friendly relations.

§ 224. —— Financial Factors.

§ 224a. Dividends.

In connection with dividends, competent management will give heed to the need, as pointed out in a previous chapter, of regularity and frequency, of stability and adequacy of dividends. It will declare and pay dividends in a manner that will best serve the stockholders tax-wise; for instance, when the personal income tax rates drop following January 1st, they will make dividends payable January 2nd and not December 31st; when a dividend exemption becomes effective July 1st, they will defer June dividends until after the first of

July. Following a period when substantial percentages of earnings have gone into capital improvements which are now earning money, they will increase dividends or declare stock dividends so their shareholders' dividends, reinvested, will be represented by an equivalent in capital stock.

§ 224b. Market Requirements.

§ 224b1. Splitting Stock.

Since, as pointed out previously, the price at which a stock sells in the market furthers or retards investment in it, a competent management, mindful of its stockholders' interests, will split the stock when its market price gets too high or when the number of shares outstanding is insufficient for the adequate distribution needed for an active market.

As noted, the stock split may be beneficial to stockholders in that it tends to send market prices up, due to the lowered price for each new share and the interest engendered by news of the split. This is particularly true when the split is accompanied by announcement of an expected increase of dividend on the new stock. Similarly, corporate benefit results, since the broader market expedites common stock financing, and the reduced per share earnings and dividends avoid calling attention of labor, consumers, competitors and potential management raiders to the stockholders' prosperity.

§ 224b1.1. Examples.

Royal Dutch Petroleum split its 1,000 guilder shares into 50 guilder shares to provide a broader market when preparing to list its stock on the New York Stock Exchange.

When United States Steel split its stock in 1955, the board chairman announced that the board believed "that the split would result in a wider distribution of the stock and make it more readily available for investment purposes."

§ 224b2. Capitalization—Leverage.

Since one of the important factors of market evaluation of a stock is the soundness of a company's capitalization, heed must be given to debt and equity ratios if a company's bonds are to have their maximum rating and its stock sell at adequate values. This requires directors to see that their debt ratio does not unnecessarily violate sound industry rules of thumb, that there be adequate coverage for debt and preferred stock requirements. At the same time, it calls for adequate debt, so that the stockholders' equity capital may not be employed where money can be conservatively obtained at bond rates of interest. Thus stockholders' profit is increased by leverage.

§ 224b3. Balance Sheet Ratios.

Similarly, while adequate cash and current assets to assure a proper current asset ratio is important, neither cash nor inventory should be excessive. Unneeded cash earns nothing; excessive inventory is not only a source of danger but may be a strong indicium of poor operation.

§ 224b3.1. Example.

An example of both of the foregoing items, poor capitalization ratios and excessive nonearning cash, was

furnished by a utility, the stock of which was selling at 22. The debt ratio was less than 20%; it had a large proportion of unneeded investments, some of which were sterile, and others of which produced returns subject to taxation in the corporate and also in the stockholders' hands. As a result of attention to the necessary financial details—and with no change in operations, or their results—the stock of the company, after a $5 distribution to stockholders on account of capital, moved from 22 to 35 in the market.

§ 224b4. Market Listing.

A management conscious of the enhancement of its stockholders' interest will list or not list its stock, as good market practice dictates. If the stock is in ample supply, listing will be indicated; if it is not widely distributed and has good dealer sponsorship, the market may be better served by trading over-the-counter.

§ 224b4.1. Examples.

Directors of the Morrison-Knudsen Company recommended that its stock be delisted, believing its shares would be traded more actively and more widely held if investment houses had additional incentive to sell it and that this might be accomplished by over-the-counter trading. The principal factor leading to this belief was the lack of any substantial volume of trading in the stock on the exchange and the Company believed that listing acted as a deterrent to interest by security dealers in the Company's stock.

The Main Central Railroad management announced it desired to dispense with its stock listing because

73,000 of its 120,000 outstanding shares were owned by its directors and principal stockholders and the management felt that the minority outstanding was too small to evidence a general public interest. It said it felt, too, that an over-the-counter rather than a listed market would increase local ownership.

Royal Dutch Petroleum Company announced its intention of listing its stock on the New York Stock Exchange and said that management was studying listing of its shares in other countries, especially Belgium, France and Switzerland.

§ 224b5. Other.

There are a variety of apparently small matters that can serve or be of disservice to the stockholders' market interests. For example, on occasion, the fact that the corporate stock has or has not a par value may burden or relieve transferring stockholders of stock transfer taxes; the existence or avoidance of stockholders' pre-emptive rights and other means of diluting or avoiding dilution of stockholders' holdings; the creation and exercise of stock options; all such matters, on occasion, may help or injure the market. More important, are matters of reports and other disclosures, and financial relations generally.

§ 224b6. Financial.

We have exhausted the subject of dividends in our separate treatment of that subject. Its relevance here lies in the fact that good stockholder relations, satisfied stockholders, can best be obtained by regular dividends and a good stock market. And, of course, the first is a prime requisite in producing the second.

As we have indicated in our summary of factors that produce stockholder good will, there are other practices to which resort can be had to produce that desirable result, and it is to be noted that increasing study of the subject by management is increasingly rendering many of these matters noncontroversial. The daily newspapers contain publicized evidence of management recognition of the value of many of these minor expediencies.

§ 224c. Disclosure.

§ 224c1. Generally.

One of the keystones of good stockholder relations is prompt and adequate disclosure by management. Failure to promptly disclose, on occasion, may be a breach of management duty; in lesser degree it invariably constitutes management fault.

A failure to promptly disclose corporate action that affects the market and that may influence a stockholder to hold or sell his stock may well be a breach of legal and moral management duty; the declaration of dividends, passing of dividends, a stock split, for example. No less than a moral duty may rest on management when a change of control through stock transfer is effected, or the corporation undertakes to reduce its outstanding stock by market purchases.

Directors have a duty to see that all stockholders are promptly informed respecting such matters, so that neither the corporation itself, nor informed stockholders, may benefit over uninformed stockholders by the use of the undisclosed information.

§ 224c2. Advertising.

It is customary in many corporate quarters not only to announce but to advertise the details of dividend declarations. Since the corporate records enable the corporation to communicate directly with its stockholders, the purpose of such advertising in financial and daily newspapers can only be to call to the attention of nonstockholders the fact that dividends are being paid. Add to such advertisements, as is frequent, notice that the dividend is regular, or quarterly, that it is the 100th consecutive dividend, add further reference to the company's products, illustrate them, and one must conclude that these represent an attempt to inform and enlighten the financial community as to the merits of the company's business and its financial condition, so that, in turn, it may advise its clients concerning the advisability of investing in the company's stock. Other means of doing this are found through the medium of summarizing, in similar paid financial advertising, the annual results of the company's business. The English go further; they publicize the chairman's remarks at annual meetings and thereby throw greater light on the company's past year's operations than can be done by figures alone. Samples of such advertisements are to be found in the daily newspapers.

§ 224c3. Releases.

A favored form of advertising a company is effected by release to the press of items of information which it will carry in its news columns. These vary from straight news concerning the company's affairs to human interest items in which the company plays some incidental

part. They include items that build the prestige of the executives, often accompanied by photographs.

Newspapers, like everyone else, become creatures of habit. One who regularly reads the financial pages will testify that certain corporations invariably get news publicity, while others, equally prominent, get nothing but the most cursory treatment. Company policy is usually the answer.

§ 224c3.1. Examples.

The following headlines are typical of everyday grist from the news columns of the Wall Street Journal:

"Stops Conveyor Belt Rips" (B. F. Goodrich Company); "Movie Ideas That Help Sales" (Westinghouse Electric); "Smarter Telescriber Machines" (TelAutograph Corporation); "Cuts Utility's Power Costs" (Southern Co-Leeds and Northrup Company); "Blatz Tries an Experiment" (Blatz Brewing Company); "Firm Invests $2 To Help Its Workers Play" (National Cash Register).

§ 224c4. Financial Contacts.

The process of educating the financial community to the merits of the company's operations and its stock, designed to enable banks, brokerage houses and investment counsel to advise their clients and customers, to make speculators in the stock investors, and to improve the credit and standing of the company and its securities with financial analysis and rating agencies, takes other forms. Executives speak before gatherings of financial analysts and credit and business associations, representatives of banking and brokerage houses are

made welcome at the company's offices and plants, inspection tours of company properties are arranged for them, and generally, personal contacts and inquiries are encouraged.

When a company's policy is to obtain funds for expansion by public stock sales, or sales of debt securities, as is the case of the utilities, it has been found salutary for financial executives also to travel about the country and hold information meetings with dealers and investment houses, insurance and investment companies and their representatives.

§ 224c5. Reports.

A corporate policy of disclosure revolves about making periodic reports of the results of company operations, sending them to the stockholders by mail and publicizing them by release to the financial and daily newspapers, and, in some cases, supplementing these by public advertising. The best practice calls for quarterly reports; the New York Stock Exchange properly requires them for stocks listed on that exchange.

§ 224c6. Statements.

When occasion requires, for example in connection with a change in payment of dividends, or a particularly good or bad earning statement, further disclosure by letters to stockholders and statements to the press, is helpfully informative.

The market in the stock, for example, is helped by adding an extra dividend to increase a regular one, when that becomes possible. It is also aided when directors declare their intention to make a dividend regular, to maintain a regular rate; when a dividend is disclosed

to be nontaxable, wholly or partly. Stockholders are guided and informed when nonrecurring profits are noted to be such.

Formal reports should be supplemented by explanatory letters. These usually refer to operations and are written by the president after submission to and consultation with the board. It is also customary and advisable, when releasing earnings, also to show the results of the corresponding prior period or periods so that stockholders may be informed, at a glance, of the company's progress, or lack of progress.

§ 224c6.1. Example.

A company was paying an increased rate for its gas, the increase being held in bond pending a commission decision finally fixing the rate. Naturally, earnings slumped by the amount of the increase. However, the fact that the increased payment was not definite was not made clear when the company issued its earning statement and, as a result, the stock sold off sharply. Doubtless, uniformed stockholders became scared and dumped their stock. Informed dealers and others who kept close to the situation, did not sell; some, who were able to appraise the rate situation, bought. Ultimately, a considerable portion of the rate increase was disallowed and the company recovered a very considerable portion of the amount by which its earnings had apparently fallen off.

Obviously, had the company made adequate disclosure when issuing its earning statement, numerous stockholders would not have suffered loss and informed speculators would not have profited at their expense.

§ 224c7. Should Be Prompt.

It must be obvious that disclosure should be promptly made. The results of operations should be released to all stockholders promptly and made available, as soon as practicable. The New York Stock Exchange requires immediate notice of a dividend declaration or omission. What is known to two or three, or half a dozen insiders, soon becomes known to many, but in the case of corporate stockholders, not to all. The informed may profit by the delayed information and do, not with venal intent but simply because business is business and its rewards go to the informed and alert. Most corporations make it a practice to telephone dividend information and other relevant action reports to the papers while the meeting is still in progress.

§ 224c7.1. Belated.

Frequently, the reason for belated disclosure is not venality, but conservatism; conservative management will not make disclosure while some "i" remains undotted. Meanwhile, the informed speculator enjoys a field day. On occasion, too, conservative management is unwilling to assume the responsibility of drawing and publicizing conclusions; it prefers silence or "no comment," unaware that it thereby assumes a greater responsibility.

§ 224c7.1.(1). Example.

The management of a rubber company, in the face of a decline in the market for its stock, said they could give no reason for "pressure on the stock." About a week later, the dividend was halved. And when asked

why that could not have been foreseen—and, of course by those in the know, it was foreseen—the management said "no comment."

It should be a corporate apothegm that when information has become available to some, either in the form of rumor or unjustified conjecture, it should promptly be made available to all. A contrary policy germinates stockholder suspicion that management and its friends seek to profit at their expense and makes for poor stockholder relations.

§ 224c7.1(2). Justifiable Delay.

It should be noted that management is sometimes justified in seeking to withhold information. Good news may make for difficulties in pending labor negotiations; it may have a bad effect on pending rate applications. However, a management that makes it a practice to make full, frank and prompt disclosure when it can do so, will find ready excuse from stockholders when, on occasion, it finds it necessary to seek delay. A secretive management, however, will thereby add to the stockholders' list of grievances.

§ 224d. Frequent Disclosure.

While management should not be secretive and should make disclosure to stockholders promptly, it is constantly faced with the need of disclosing or not disclosing information to the diligent, indeed the ubiquitously inquiring stockholder who wants to get the "edge" on others. While the diligent stockholder is entitled to his just reward, management must be alert to protect the main body of stockholders against the few energetic and ferretlike speculative professionals. The obvious

defense of management against individual inquirers is not refusal or concealment, but disclosure, prompt and frequent disclosure to all.

For an extreme example, if, as in the case of many utilities, figures are released on a month-to-month basis, management should properly refuse to give them to an inquiring stockholder prior to release. On the other hand, if management releases information only semi-annually, an inquiring stockholder is nevertheless entitled to know the result of the quarter's operations. The answer here is not justification or lack of justification of answering such an inquiry; instead the posing of the problem makes it clear that withholding information from all the shareholders for as long as a six months' period is bad and insupportable practice. Thus the conclusion is made clear that information should be released with reasonable frequency and since it is in the nature of operating management, for trade, competitive, labor and other reasons, to tend to be secretive, the board, in its capacity of stockholder representatives, should seek to keep stockholders informed by frequent releases.

§ 224e. Disclosure by Board Members.

Board members should be loath individually to release corporate information of a specific nature. That, as with all functions, is for management, either operating management or the board, or both. It must not be forgotten that individually a director has no power; he functions as an integral part of a board.

However, one must also be practical. As in the case of management, a director is constantly called upon by individual stockholders for expression of fact and

of opinion. There can be no valid objection to the disclosure by a director of general information or of his opinion. But as in the case of management, the prompt and frequent official release of proper information, should minimize and enable a director to handle individual inquiries.

§ 224e1. Example.

With a prospective merger being rumored, a director of Studebaker, asked about the merger, answered: "I don't want to make any comment as a director. Any comment should come from management."

§ 224f. Objections to Disclosure.

The standard in-the-past objections of conservative management to disclosure have rested upon the ground that it did not want to inform competitors of its activities; in these later years, labor, the taxing authorities, the rate-fixers have been the favored whipping-boys. It needs no argument to demonstrate that, with even a small organization, people who want to find out how things are going can do so. Labor unions get company reports; in addition, as management finds pipe lines into labor ranks, labor knows what is going on. Tax and rate people, competitors, are neither blind, deaf or dumb; enlightened management reconciles itself to the inevitable.

Another stuffy argument advanced is that stockholders are not really interested. The best answer to this is to get them interested and thus create corporate and management good will. Even the fact that most stockholders do not read, and that many who read do not understand reports, however clear, is no excuse for

denying those who want to be informed the opportunity of protecting themselves. The prophylactic effect of disclosure is not alone for its aid to the patient as for its effect on the doctor. As the physician cannot talk freely and long conceal his ignorance or impotence, so corporate authorities cannot disclose fully and remain surreptitious or ignorant. And, when honest and competent management makes disclosure, suspicion and resentment evaporate.

§ 224g. Annual Report.

Practically every publicly owned corporation issues annually a report of its past year's operations. These range from a statement of figures to an elaborate and illustrated brochure containing much written matter. The purpose of the annual report is twofold, one, to inform the financial analyst and the statistically minded stockholder, and second, to build stockholder interest, confidence, pride and good will in the corporation and its management. The first purpose is served by the necessary statistical data and accompanying explanations, usually contained in the president's letter which opens the report; the latter purpose is served by making that data comprehensible to the average stockholder, by inclusion of graphs and charts, tables of comparisons with the results of past years' operations, by narrative and illustrations showing the nature and extent of the company's operations, and finally, where feasible, by revealing future plans and prospects. The standard annual report also gives the names and connections of the directors and lists the principal personnel of the company.

Within recent years, management has been stimulated

to make its annual reports increasingly attractive and readable, by using expert services to promote color, design, format and illustrations—some even humorous cartoons—to a surfeiting point of elaboration, with the consequence that the trend has turned in the direction of simplicity. Some companies took to the practice of issuing two reports, one, to satisfy the statistically minded, the other to promote stockholder interest and good will. Other companies circulate an additional report for employees. Some companies issue interim "progress reports" during the year, in an effort to maintain the good will they seek to create by annual reports.

While the annual report should be sufficiently informative—and some, like the old-time report, are still mere gestures—the tendency to overelaborate and over expensive annual reports has been somewhat overdone in recent years, leading to criticism which, in turn, has caused some sensible reaction.

§ 224g1. Examples.

Of criticism:

From the Valley National Bank of Phoenix, Arizona:

"The annual report has become a thing of beauty and a joy for printers . . . Today it takes a CPA to tell what a company made . . . Preparation of the report calls for the joint efforts of the Advertising Dept., Publicity Dept., Public Relations Dept., New Business Dept., Old Business Dept. . . ."

Another from a Western source—The First State Bank of Pilcher, Oklahoma, report was in the form of a simplified statement headed "Statement fixed so even you can understand it."

Contra:

On the other hand, The Financial World, a New York financial publication, long an advocate of adequate annual reports, states that after studying 5,000 annual reports, including those of the larger companies, one third met requirements for "awards," a percentage which increased from .3 in 1940.

§ 224g2. Approval by Directors.

The contents of all reports which are ordinarily prepared by management with or without outside aid, should be submitted to directors for examination and approval before being released; the contents of the annual report should be the subject of suggestion and even greater consideration by the board. In this connection it might be noted that the standard form of annual report is directed to the stockholders and signed by the president after the statement "by order of the board." The Canadian Pacific Railroad's annual report, following the English custom, is made by the board.

§ 224h. Other Means.

As the annual report is supplemented by semiannual or, preferably, by quarterly financial statements, and by interim brochures, so other means of informing stockholders are pursued by companies. The house organ in some cases is written to awaken and maintain stockholder interest and it is of great value in companies that seek to make their stockholders their customers: companies selling food, household goods, automobiles, for example. Many companies get special newsletters out to stockholders from time to time during the year.

Many accompany dividend checks with attractive messages bearing inserts.

§ 225. The Annual Meeting.

The opportunity for stockholders to meet and get acquainted with the directors and officers and to view plants and facilities of the company occurs annually on the occasion of the annual meeting. The manner of conduct of this meeting is often an index to the attitude of management towards the stockholders and a reflection of stockholder relations.

§ 226. —— Adequate Notice and Information.

Generally, annual meetings are held in the Spring following transmission to the stockholders of the annual report. We have discussed the technical details of the annual meeting heretofore in connection with the election of directors. Through the medium of the annual report, stockholders have been informed concerning the present status and the progress of the company during the past year and can come to the meeting and make further inquiry, if the information they have received is not complete or leaves them in doubt.

In addition, stockholders will have received notice of the meeting, including proposals to be voted upon and supporting data and information concerning the latter. At least, this is so in the case of listed companies, under SEC regulations; unlisted companies have varying practices, the least of which is to give stockholders only the barest information of what is to be done at the meeting.

Invariably, a board is to be elected, and, except where management has a controlling stock interest and is

willing to make its disregard of its minority stockholders a matter of record—which, though unusual, does occur—a proxy to management's representatives is enclosed. We discuss the subject of proxies and their contents in a previous chapter.

In the case of listed companies, among the proposals of which notice is given are those suggested by minority stockholders, in accordance with SEC regulations. This also finds discussion in the previous chapter.

Aside from legal requirements, proxy material should be understandable. An accompanying explanatory letter is helpful where action to be taken at the meeting needs to be explained. New York Central ran an advertisement in the newspapers pointing out that its 40 pages of proxy material was "much of it in required legal language" which, according to the advertisement "does not make easy reading." It quoted a shareholder as saying "whoever made up that printed form was strong on economy of paper . . . hundreds of your stockholders are going to send in proxy authorizations wrongly marked—that is marked to vote not the way they meant to vote."

It may be that the management was moved to so advertise because it feared it would not receive the necessary proxies to enable it to vote approval of its resolution to have the corporation reimburse its 1¼ million dollar proxy contest cost.

§ 227. —— Time and Place.

Generally, state statutes require that the annual meeting of stockholders be held at the principal office of the corporation in the state of incorporation. Since many corporations select a state for incorporation for

tax and other particular reasons—see discussion Part II—and the formally designated "principal place of business" is frequently no place of business at all but a remote mailing address, the annual stockholders' meeting is not necessarily held at a place designed to encourage stockholders' attendance.

This practice has been a source of much stockholder and financial writer criticism.

It is to be noted that because of the advantages of the Delaware corporation law, many of our large corporations are incorporated in Delaware and hold their annual meetings in Wilmington, although the Delaware law permits annual meetings to be held outside the state. Despite the oft-repeated criticism of holding meetings in Wilmington, many corporations adhere to the practice. Bethlehem Steel management, for example, voted down a stockholder resolution at the 1954 meeting to hold annual meetings in New York instead of Wilmington.

§ 227a. Example.

Ralph Hendershot, financial writer of the New York World Telegram, said in an article devoted to the General Motors annual meeting: "Harlow H. Curtice, president of General Motors, had a number of encouraging things to say to stockholders of the company yesterday at the annual meeting. Why he elected to say them in Wilmington, Del., a rather difficult place for stockholders to reach, however, is a $64 question officials and directors of the big automobile concern should ask themselves regularly over the next 12 months . . . If General Motors were one of our laggard companies, with old-fashioned ideas and methods of operation, the

fact that it still holds its annual meetings in Wilmington would occasion much less surprise. It would be assumed that it was not particularly interested in having its stockholders attend . . . But we refuse to believe that General Motors lacks concern for its stockholders . . . Nevertheless, the location of the annual meeting suggests just that . . ."

§ 227b. Avoiding Criticism.

Manifestly, the average intelligent management will seek to avoid such criticism either by changing the place of meeting, if the legal obstacles can be overcome, or by offering transportation and other advantages to overcome the inconvenience of attendance. One means of partially overcoming the otherwise unavoidable is the holding of supplemental information meetings in places convenient to stockholders.

§ 227b1. Examples.

International Telephone and Telegraph Company arranged to hold its 1955 stockholders' meeting at a leading hotel in Chicago foreshadowing, according to a company spokesman, "sessions in other parts of the United States convenient to sizable groups of International Telephone & Telegraph stockholders."

The 1954 meeting was held at a New York City hotel; the 1953 on the grounds of the company's subsidiary at Nutley, New Jersey. Previously, its meetings had been held at Baltimore, in the state of incorporation.

Mr. Ronald L. Prain, chairman of the British company, the Roan Antelope Copper Mines Limited, came from Lusaka, Northern Rhodesia, Africa, to hold an "information" meeting for American stockholders in

New York City, after holding a similar meeting in London for the benefit of the company's United Kingdom stockholders. Mr. Prain said he had adopted this course of action in the interest of improved stockholder relations. The official stockholders' meeting had previously been held in Rhodesia, where the necessary formal action had been taken.

§ 227b2. Encouraging Attendance.

As in the case of the doctor, it is sickness that best stimulates attendance. However, it is the case of the normal company that we are considering, the company that seeks to build its stockholder relationship and good will.

Many companies, in their proxy material, urge stockholders to be present in person at the annual meeting. Practically all companies seek a high percentage of proxies; many employ professional solicitors and mail follow-ups to jog careless shareholders.

Peoples Gas and Coke encourage shareholder cooperation in this respect by acknowledging with thanks the receipt of the stockholder's proxy.

New York Central advertised in order to obtain proxies for the first annual meeting following Young's victorious proxy contest though there was no subsequent contest.

Some companies seek to encourage attendance in tangible fashion.

American Telephone and Telegraph Company changed the place for the holding of its 1955 annual meeting because the 1954 meeting place had proved inadequate for the more than 1400 stockholders at-

tending. The company made provision to televise the meeting for the benefit of overflowing stockholders.

The New York Central Railroad provided special trains to take stockholders to Albany, scene of the annual meeting. Many companies provide bus service from trains and some advise stockholders of train and bus times. New York Central and General Electric hired armories and set up loud-speaker systems to accommodate the large crowds of expected stockholders.

Many companies provide lunches for attending stockholders. Examples include New York Central, Standard Oil of New Jersey, International Telephone and Telegraph, and many others.

Sinclair Oil stockholders were shown through a display of Sinclair products. Many companies display charts and photographs on the walls about the meeting room, others show motion pictures of the company's activities and kindred subjects of interest to stockholders.

§ 228. —— Atmosphere at Meeting.

The atmosphere at an annual meeting may tend to build or discourage shareholder confidence and cooperation. On the management side, a frank and confident handling of the meeting contrasts with a secretive, anxious-to-get-it-over-with, resentful attitude.

On the stockholder side, intelligent and cooperative stockholders will encourage a consistent management attitude, as overcritical and heckling shareholders will encourage an opposite management reaction.

§ 228a. Professional Shareholders.

The professional shareholder, of whom there are a

number of examples, may make a nuisance of himself and waste the time of stockholders or management, or may make a useful contribution, largely depending on his purpose and on the type of management concerned. Even a mere publicity seeker may shock torpid management into a realization that times have changed; a propagandist may be sincere in his motives and intelligent in his approach to a reactionary management. Publicity, too, is often a therapeutic; many people who do not appreciate the obvious will believe it once it gets into print. Here, as always, conclusion should be fluid and rest on the facts.

§ 228b. Competent Chairman.

A competent chairman does much to make a meeting interesting and illuminating. He can keep it in control without too much difficulty even under the most adverse circumstances. On the other hand, a poor chairman, unaccustomed to presiding at public gatherings, conscious of his public speaking deficiencies, can ruin what otherwise would be a good meeting and will readily lose control; particularly if his self-control is not of the firmest, or his sense of humor and patience is lacking. Where the president or the board chairman is not capable of handling the meeting, he should permit another to handle it, letting the direction come from the chair and himself participating from the platform. The possible loss of face can readily be compensated by the atmosphere created at the meeting.

At the Montgomery Ward 1955 meeting at which the Wolfson interests conducted a proxy contest, Sewell Avery, the 81-year old chairman, whose tenure was in dispute, did not preside. When called upon, it became

evident that he was physically and mentally incapable of running the meeting.

§ 228c. Presence of Directors.

Directors should be present at the annual meeting and should be introduced to and circulate among stockholders. This makes for stockholder confidence and often affords a ready means of encouraging stockholders to voice complaints and offering directors an opportunity of discussing and answering them, thereby contributing to the knowledge and information of stockholders and directors alike. Since the annual meeting attracts employee-stockholders, it likewise establishes contacts between directors and employees whom otherwise they would not meet.

Management can encourage directors' attendance by scheduling the organization meeting of directors to follow the annual meeting, as noted previously.

At a meeting of a utility board in preparation for the annual meeting, a question was raised whether the organization meeting of the board should be held immediately following the annual meeting of the board. The discussion made it clear that the basic question involved was whether the corporation desired to stimulate stockholder attendance at the annual meeting or permit it to be perfunctory; that in the former case it would be advisable to stimulate directors' presence at the annual meeting by holding the organization meeting immediately following.

§ 228d. Conduct of Meeting.

The chairman should encourage fair and intelligent questions from stockholders and the *interregnum* which

comes during the counting of the ballots is the best time to ask and answer them. The answers should also be fair; they should not be brush-offs. Nor should they be blindly defensive. Antagonism should not be created by contemptuous or dictatorial treatment, even of stupid or silly questioners. The chair should be patient and tolerant. He should create stockholder sympathy for the management, not for stockholders treated harshly. Questions should be referred to and answered by members of management present and armed with the needed information, rather than have the chairman, with incomplete knowledge, undertake to fumble them.

Directors employed in this capacity make a considerable contribution to stockholder confidence by demonstrating to stockholders, by their ability to answer questions, that they are informed, working directors and not mere figureheads.

It is customary for an agenda to be prepared for the meeting and various persons, usually employee or director-stockholders, are designated to make the various motions, thus insuring that the necessary formalities are properly complied with. In so doing, it is preferable to permit a number of persons to divide these tasks between them, thereby avoiding a steam-roller, cut-and-dried atmosphere. Similarly, while the chairman's speech is prepared in advance and read, it makes for a better atmosphere if his delivery is informal and casual rather than stiff and pedantic.

On occasion, the purpose of the meeting may be best served by taking the offensive against rude and unfairly critical stockholders; particularly when they are serving some special interest and obviously have no desire to be fair or open-minded. In such situa-

tions, a chairman with a sense of humor and an ability to subject the offender to gentle ridicule, will find support in the meeting and convert an antagonistic attitude into a friendly one.

That progress is being made in these directions is attested by an article in the New York Tribune headed: "Greater Candor Marks Holder Meetings," and which, referring to bank meetings, went on to say: "Perhaps an outstanding feature of the meetings, . . . was that most of the New York bankers bared their thoughts more than before . . . All told, the meetings . . . were constructive and informative as well as cordial. Sour notes were few and management bent over backwards to answer questions, however irrelevant."

And in an article in the New York Times headed "Banks Investors Acclaim Officials," it was noted that "stockholders insisted on their right to question management and, as usual in recent years at least, they were patiently and politely heard," though the reporter noted "sometimes, that was not easy."

§ 228d1. Examples.

From press reports of annual meetings, the following is culled to illustrate various phases of the conduct of meetings:

"U. S. Steel held its annual meeting yesterday and the deliberations ranged from the economic to the comic. Considered at the 2½ hour session were such diverse topics as the upturn in U. S. Steel's business, the waistline of its Chairman . . . the propriety of holding annual meetings in 'dance halls' and the rights of women stockholders . . . The meeting, attended

by almost 600 stockholders, opened on a light note and was marked by occasional amusing interludes, as well as sharp exchanges."

"Questions of Stockholders Enliven A. T. & T. Meeting" . . . The "president . . . weathered a storm of questioning . . . defended the reelection of . . . a director . . ."

"The annual meeting" of Technicolor, Incorporated, "attended by about 35 persons, lasted for about two hours. Stockholders and the presiding officer wrangled furiously, at times, over two separate questions. 'Point of Order' remarks were loud and frequent. One question revolved around" the president's "salary. The president was reluctant to disclose it publicly . . . Before the question could be resolved the two newsmen at the meeting were formally asked to leave the room. And they did so because they did not have proxies." The president told the stockholders the figures they wanted to know. It was learned later from stockholders leaving the meeting that "the president said . . . his cash salary was $108,000 annually . . . The other issue debated concerned a loan. The President was unwilling to disclose the specific purpose of the loan . . ."

The Sears Roebuck meeting "was brief and as it ended" the chairman "was given a standing ovation from the 100 stockholders present."

Reporting the Montgomery Ward 1954 meeting, the New York Times said: "In contrast to several rather heated annual meetings (of) the big merchandising company in recent years, today's session was calm. 'This has never happened before', The chairman observed, and he then turned and asked the stockhold-

ers, 'Do you know of any softness that has come into the situation?' "

§ 229. —— Post Meeting Reports.

It is becoming practice in many companies to send stockholders reports of the annual meeting, summarizing the action taken at the meeting.

A typical post meeting report—one of Humble Oil—advised that at the 1954 meeting, 95.7% of the outstanding shares were represented, gave a summary of the president's report of operations, the status of the company and the industry, and generally summarized the action taken at the meeting.

Other company practices along these lines: Consolidated Edison Company issues "News and Views," a stockholders' quarterly which includes post annual meeting report; American Telephone and Telegraph Co. also incorporates a post annual meeting report in its "Share Owners' Quarterly." Commonwealth Edison of Chicago, Columbia Gas, Southern Company, American Gas and Electric, Socony Vacuum, Cleveland Electric Illuminating Company and Detroit Edison are among the many companies that send stockholders such reports. Socony Vacuum offers stockholders a transcript of proceedings on request; only 100 of 175,000 stockholders requested it. General Motors furnishes a brief report and offers a summary but receives few requests. Fifteen per cent of Standard Oil of New Jersey's stockholders answered its request for vote on advisability of sending post meeting reports; 76% voted "yes." Peoples Gas of Chicago asks for comments; few are received and those generally complimentary.

At one meeting, when the chairman expressed man-

agement's opposition to this practice, saying stockholders should attend or else be uninformed, a stockholder asked whether the company's public relations man agreed with the management's opposition.

Manifestly, all stockholders cannot be expected to attend an annual meeting and management would be shocked at the thought that they might do so. Equally obviously, no harm can come from keeping stockholders informed and a report of an annual meeting serves the cause of creating and maintaining good stockholder relations.

§ 230. Other Means.

There are other means employed by management to build stockholder good will.

§ 231. —— Stockholder Communications.

The effort to make stockholders feel like share-owners, giving them a sense of participation in the corporate affairs, starts with a welcoming letter to a new stockholder—and frequently, this serves the double purpose of calling attention to the company's products or services and inviting him to become a consumer or customer. This practice is continued by sending messages and quarterly financial reports to shareholders to accompany dividend checks. Some companies write shareholders when they sell their stock, asking why they did so, and use information received for corrective purposes.

An essential supplement to creating and maintaining good will in this fashion is the practice of sending courteous and informative replies to stockholder communications; avoiding brush-offs.

Bell Telephone advertised that "in the past year we have answered more than 180,000 letters from owners of our stock and debentures . . . in addition to information sent to all shareowners . . . many a time . . . we speed the reply by telephone . . ."

The Solid Gold Cadillac, a play produced on Broadway satirizing corporate practices, ended satisfactorily in a huge and spontaneous stockholder reaction. However unrealistic, a solid core of truth is to be found in the assumption that the note sounded by an ingenuous employee, who, for want of assigned tasks, embarked upon a campaign of writing friendly notes to stockholders, productive of stockholder cooperation.

The New York Central proxy contest was productive of a number of management communications to stockholders which, sent in season, might have resulted in greater management support. For example: headed "Highlights of the White Program," management discussed prospective savings, increase of freight revenue, new services and conveniences for freight customers and passengers and a "Bold New Plan."

Some companies go so far as to canvass stockholders in an effort to obtain their opinions concerning specific problems. Some use questionnaires.

Western Union has had a "shareholder interview" plan for some years. The company reported that almost 85% of the shareholders volunteered comments, most of them expressing their approval of the program.

Citizens Utilities Company asked its stockholders for advice as to the content of the company's annual report. It is to be noted that a good many companies accompany their annual report with a return post card to enable shareholders to comment thereon.

§ 232. —— **Referral of Policy Decisions.**

While directors should be willing to assume and discharge their responsibilities, there is an area of policy making where reference to shareholders serves useful purposes while, conversely a failure to do so may breed shareholder antagonism. When directors are called upon, for example, to pass on pension plans or stock bonus plans or options, whether or not the law requires submission to the stockholders, it is helpful in breeding stockholder confidence and good will to do so. Even more important, failure to do so may create stockholder resentment. In this fashion too, directors share, though they do not shirk, some of their responsibilities. As an example: Although its charter did not so require, Philip Morris asked its stockholders to vote on the proposed acquisition of a controlling stockholding interest in Benson and Hedges.

§ 233. —— **Management Personnel.**

The personnel of the officers and directors is frequently an incentive to stockholder confidence or lack of confidence, as are the shareholdings of members of management. Investors will buy and hold stock in companies manned by persons of repute; conversely, they will have no truck with companies whose president is known to be sharp and tricky.

When stockholders find members of management buying and selling the company stock as its prospects vary from good to bad and directors voting officers excessive stock bonuses or granting underpriced stock options or excessive salaries or bonuses, they properly feel that its management is not devoted to the stockholders

but is seeking personal speculative advantage at their expense, making disclosure after personal use of corporate information and the like. Thus lack of confidence is bred.

§ 234. —— Evidence of Confidence—Result.

When the stockholder is a customer or when the consumer becomes a stockholder, the evidence is obvious that stockholder and customer confidence has been created and management is doubly armed. High response to proxy solicitations is a sign of stockholder confidence. A low share turnover disclosed by the transfer sheets is another such indication.

Within recent years, the public utilities have sought to repair the inefficiencies of their consumer-stockholder programs of the twenties and very definite gains have been made in putting stock into the hands of consumers and others in the local territories. The consequences become apparent when public power advocates seek political support, when Eastern financiers attempt to disturb local management and even when lessened rate opposition develops.

§ 234a. Examples.

When it was charged during a federal power hearing that the Idaho Power Company was a New England concern with headquarters in Maine, the president disclosed that 59.48 per cent of the stockholders were Westerners, of whom 40% were residents of Idaho and Oregon.

In the course of an attack on management of Puget Sound Power and Light Company, incorporated in Massachusetts, the management reported that of its

12,000 stockholders, about 40% lived in the State of Washington, where the Company's system is located, and over 52% were residents of the three Pacific Coast states.

§ 235. —— Sources of Dissatisfaction.

As previously noted, management can actively create stockholder ill will in a number of affirmative ways. For example, stockholders' disaffection results when a controlling stock interest is sold at a price in excess of market while no similar offer is made to the minority. The law permits this but if no adequate market exists at or near the majority sale price, a dissatisfied minority stockholder group results to plague the incoming new management.

Similarly, where existing management reinvests corporate funds in alien enterprises, businesses foreign to the basic corporate purpose, stockholders who cannot find an adequate market for their holdings may properly feel they should have an opportunity afforded them by management to withdraw from the venture. The Securities and Exchange Commission, for example, in permitting a former utility company to become an investment trust, imposes the condition that dissenting stockholders be given opportunity to withdraw at existing values for their stock.

Other similar instances arise from time to time which may result in mass dissatisfaction. Directors should be alert to such possibilities since they tend to destroy quickly what competent management has sought to build over a considerable period of time.

CHAPTER XIV

Directors' Disabilities and Disqualifications

§ 236. Generally.

As the director's office carries with it privileges and duties, so it involves disabilities and disqualifications. These necessarily flow from the duties charged upon the director.

Heretofore we pointed out that the director's duties fall into four categories, i. e., (1) those the statutory law imposes on him; (2) the duty of care and control of the corporate assets; (3) the duty of managing the corporate affairs; and (4) the duty of representing the stockholders in and about the corporate affairs. We also pointed out that the duties of the first and second classes were such as required performance by the di-

rectors themselves; that the responsibilities they entailed could not be delegated to others.

To the slight extent the statutory law prescribes qualifications for the director or restricts his selection, these constitute disqualifications or disabilities, which we discuss separately hereafter.

§ 237. Care and Control of the Corporate Property.

It must be manifest that when one man entrusts the care, custody and control of his property to another, the recipient of that confidence must be held to have assumed an obligation to faithfully administer the task entrusted to him. The very words that describe the relationship force the conclusion that the law necessarily draws, i. e., that it is one of trust and that the recipient who accepts the trust assumes the duty of performance, a duty that requires personal attention and one that cannot be shirked or delegated without possibility of liability.

In simple essence, this is the measure of a director's duty, his fiduciary obligation that arises when he assumes the care and control of the corporate assets.

§ 238. Managerial and Stockholder Representative Duties.

Conversely, we pointed out heretofore that the director's managerial and representative duties were not intended by the corporate charter to be performed by the directors, but to be delegated to the executives. As contrasted with the care and control of the property entrusted by one to another, the duty of managing contemplates operating for profit. In turn this involves primarily the exercise of business judgment, and this

is the qualification not of a trustee but of an agent. Consequently, within the realm of the managerial and representative duties of the director, the law does not regard him as a trustee or a fiduciary, but rather as an agent, and his derivative disabilities and liabilities are correspondingly lightened.

§ 239. Disabilities.

§ 240. —— Generally.

The law's requirements, which are the source of the disabilities and liabilities imposed on directors, may be summed up tersely by saying (1) the director must be honest, and (2) he may not be negligent. The first requirement varies in degree when we are considering the fiduciary obligations of the director respecting the care and control of the corporate property and the performance of managerial duties, because the law not only requires a trustee to act with strict fidelity and loyalty, but forbids him to put himself in a position where he may be tempted to act otherwise. This trustee rule is the basis of disabilities with which the law charges a director when he takes the office.

§ 241. —— Subordination of Personal Interests.

Thus, the director may not use his office or its perquisites as a means of preferring his personal interests to those of the stockholders he has undertaken to represent or the corporation he has undertaken to serve. In turn, this prevents the director from dealing with the corporation to its disadvantage.

§ 241a. No Dealings with Corporation.

In given situations, usually the result of express statutory provisions, a director may not deal with his corporation at all. So, it is usual to forbid, by statute, a corporation—and particularly a bank and other financial institution—from making a loan to or guaranty for the benefit of its directors. And in many states, the prescribed penalty is not only civil, but criminal. In many states, a director of a financial institution is forbidden directly or indirectly to profit by or participate in any transaction of the corporation with a third party.

§ 241b. Restrictions on Dealing with Corporation.

Usually, a director is permitted to deal with his corporation.

There is no sound reason, in law or in morals, why a man who does business with a corporation should not serve as a director, and conversely, why a man who is a director should not do business with his corporation. In discussing the selection of directors, the difficulty of obtaining the services of competent men became obvious. Likewise, in considering directors' compensation, like difficulty appeared in adequately paying directors for competent service and it appeared that legitimate incentive might be found by men who might anticipate profit from legitimate business dealings with the corporation.

The common and everyday occurrence that poses this problem is the professional retainer of the lawyer, engineer, accountant or banker on the board. As heretofore concluded, there can be no valid objection to such a relationship provided not only technical legal rules are complied with but fair dealing results.

The technical rules are simple. Primarily, they require that when a director has dealings with his corporation, whether they be direct or through the medium of another corporation in which he has an immediate interest, he must make full and frank disclosure. That is the director's duty. In ordinary dealings, the director can undertake to be shrewd and overreaching. Here, he may not be. That is his "disability" in dealing with his corporation.

Nor may such a director make undue or inordinate profit. If there is a market or competing price, that must prevail. He may not measure his profit by the corporate detriment. To the extent that his personal interests unduly collide with those of the corporation, he must subordinate his own. And when there is no guide available, the honest director will bend backward so no one can fairly contend he has borne too heavily on his "insider" relationship.

Every situation poses its own problem that requires the application of the principles stated.

§ 241b1. May Not Vote or Otherwise Influence.

In extension of the effort to assure honest dealing between the director and his corporation, the law adds another disability by prohibiting the director from voting on, participating in, or otherwise influencing the corporate consideration of the proposal in which he has a personal interest. The director's presence at a meeting considering the proposal will not be counted to constitute a quorum. Of course, his vote may not be counted for the proposition; if it is needed to carry it, the board approval is void. If he otherwise influences an approving vote, though his own vote is not needed,

the law may term the approval voidable at the instance of the corporation or its stockholders; and in some cases, it will declare it void. Accordingly, to avoid any intimation of influence, the director should not be present during the consideration of or the vote upon his proposal. Even though he not be present, as in a New York case, if the Court finds he dominated the board, it will declare the contract void.

When, for example, RKO Pictures sold its assets to Howard Hughes, its controlling stockholder and board chairman, the action of the board was taken in the absence of Mr. Hughes, and preceding the vote the board membership was enlarged and board members resigned and were replaced, so that a disinterested majority could approve the sale.

When the law is invoked, it will scrutinize carefully any transaction between the director and the corporation and may set it aside if there is any evidence of fraud, unfair dealing or detriment to the corporation; and it will throw the burden of showing the lack of these elements upon the defendant-director.

In many corporations, the charter or bylaws contain express provisions permitting transactions between the corporation and its directors; in some instances, there are special restrictive conditions, such as requiring a two-thirds vote of the board. In special cases, there may be special statutory requirements.

§ 242. —— Dealings of One Corporation with Another.

§ 242a. Interlocking Directorates.

When two corporations having identity of directors undertake to deal with one another, disabilities come to

the fore. When only a minority have dual identity and no question of domination is present, the disabilities imposed by the law in the case of a director dealing with his corporation apply and satisfy the law's requirements as to the technicalities and fairness.

However, when one corporation or one interest dominates or controls another, by stock interest or otherwise, rules respecting mere individual disabilities will not suffice; such a contract will be voidable at the instance of a minority, it will be scrutinized closely and on slight proof of fraud or overreaching it will be set aside.

So, for example, a federal judge issued a preliminary injunction blocking a merger of two companies upon the allegation that the president of one had arranged the merger to benefit himself and other principal holders of the stock of the other, at the expense of the latter's stockholders.

Likewise, in a suit brought by one oil company against another, the plaintiff charged that the defendant company, through the control exercised by a common majority stockholder, required plaintiff to pay an inordinate share of joint exploration and development costs and sought recovery of the excess.

§ 243. —— Restrictions on Stock Transactions.

§ 243a. With Other Stockholders.

The law will not permit a director to overreach other stockholders; generally, it requires a greater measure of fairness in his dealings with other stockholders than it does in his dealings with strangers. So, for example, a director in receipt of special corporate information which has not been disclosed to the stockholders, may

not privately purchase a shareholder's stock or sell his own to a shareholder without adequate disclosure of the essential information.

For example, in a suit brought by selling stockholders, an Illinois court held that, on a charge that a director knew facts which affected the value of stock of the corporation which he could make known without injury to the corporation, he was bound to make such disclosure before acquiring the shareholder's stock.

In another situation, the SEC sought to restrain a director of the Naumkeag Steam Cotton Company from soliciting stockholders to sell him their stock, alleging that the director knew and did not disclose to the stockholders that negotiations were pending for a merger of the Naumkeag Company and that another concern had offered to buy the Naumkeag stock at a price greater than the director was offering.

A management controversy brought forth the charge that directors had been buying the preferred stock of a corporation at a discount in anticipation of a directors' resolution to retire the stock at par. The fraud, of course, was worked not upon the corporation since, in any event, it would have paid par for the stock but upon the selling stockholder left in ignorance of the directors' intention and purpose.

§ 243b. Generally.

By federal statutes and rules, certain disabilities and concurrent requirements are imposed upon directors and controlling stockholders of publicly owned and listed companies. Such a director must disclose his stockholdings immediately after taking office and must thereafter report monthly any changes therein.

A director of such a company may not retain any profit made by buying and selling the stock within a six months' period. Any such profit is recoverable by the corporation in a suit brought by it or a stockholder. This disability is so stringent that it cannot be avoided by earmarking stock bought or sold, since the law considers the last stock bought or sold the first stock affected, regardless of the certificates of stock transferred.

This provision, according to the act, and in its language, is "for the purpose of preventing the unfair use of information" which the director may obtain "by reason of his relationship." Likewise, the director is forbidden to make "short sales" or "sales against the box" which are not followed by delivery within twenty days, "arbitrages" only excepted.

Another practice, hallowed in former years, was the anticipatory purchase by directors for their own account of securities of their corporation—bonds and preferred stock—at market prices below their redeemable values, when the director knew, by virtue of his relationship, that the corporation expected to redeem these securities at higher values. Later, the foresighted director would turn the purchased securities into the corporation, at an assured and handsome profit. Or the director might compete with his corporation in making purchases in the open market. Or, because he had acquired a block of bonds or preferred stock, the director might conceive the idea and vote to have the corporation retire or refund the issue. Obviously, there could be as many variations on this theme as a virtuoso could contrive on his violin.

These practices still prevail unchecked except where the law has been able to get particular situations within

its clutches. So, if the purchases are of stock or bonds of a corporation undergoing reorganization, the court is authorized to apply the provisions of a section of the Bankruptcy Act which says that the judge may "limit any claim or stock acquired" by a fiduciary in contemplation or in the course of the proceeding "to the actual consideration paid therefor." In a number of cases, this power has been exercised, to the surprise and chagrin of a director who otherwise would have netted a handsome profit.

Similarly, in a utility reorganization, under the provisions of the Federal Public Utility Act of 1935, the Securities and Exchange Commission undertakes to pass upon the purchase of stock and bonds by a director. In one recent case the Commission limited an officer and director to his cost, plus 4%, though the difference between cost and the value of the securities once the reorganization plan became effective, approximated several million dollars. This case went to the Supreme Court twice; and the Commission was upheld.

§ 244. —— Corporate Opportunity.

A director is disabled from acquiring a profit that accrues through the corporate channel. Obviously, he may not divert such an opportunity from the corporation to himself. And his trust relationship is such that the law disables him from grasping a corporate opportunity though the corporation is unable or unwilling to take advantage of it.

For example, if a real estate broker comes to see the director of a corporation with the suggestion that the corporation be interested in buying a piece of property, the director's disability is such that he may not offer

to take the property without offering it to the corporation. Nor may he influence the corporation to refuse it, so he may buy it himself. If he does and makes a profit, the corporation may recover it in a suit brought by the corporation or its stockholders.

There are cases in the books that illustrate this basic disability of the director. So, when a company had under consideration the purchase of a soft-drink business, which it needed to round out its own candy business, the president could not legally or morally acquire it privately. When he did, a subsequent suit by stockholders of the candy company resulted in a court order requiring the president to turn the business over to his company. There were some additional facets to this case, although they merely served to intensify the inevitability of the court's action. For one thing, it appeared that the president had built up the soft-drink business by using the company's resources, money and good will, and, for another, it developed that he had maintained the business in competition with that of the company.

In another case, directors claimed that stock of another corporation was offered to directors individually and they purchased it. In a later suit brought by a receiver of their company, it was found that since, in reality, the offer was intended for the corporation, the directors could not keep the stock but were required to turn it over to their corporation.

It might be noted that, in this case, the directors also contended that their corporation lacked funds to purchase the stock. But the court held that the circumstances of the offer disqualified the directors from pur-

chasing the stock individually even though the corporation could not have purchased it.

As bearing upon the court's finding that the corporation needed the stock in this case, the court, in another case, absolved an officer who bought coal lands that his corporation might have bought, because, as a practical matter, the corporation had plenty of coal lands and had no real practical use for the additional ones.

§ 245. —— Secret Profits.

Nor may a director make a personal profit out of a corporate transaction.

So, two directors who received a "kickback" of $33,000 out of commissions paid by the corporation to brokers who placed an issue of corporate bonds, were required to return their "secret profit" to their corporation. Similarly, when a director had a "dummy" buy a piece of land from his bank for $50,000 and resell it to an "outsider" for $80,000, the errant director was not permitted to keep the $30,000.

In another case, a director lost an extension of an expired lease held by his corporation, though he got the landlord to put the extension in his individual name.

In such a situation the director may not contend successfully that the price paid by the corporation was fair or that the corporation was not otherwise injured. The point is that the director has a disability which prevents him from personally profiting from any such transaction.

These disabilities carry beyond the termination of a director's connection with the corporation.

Accordingly New York's highest court held that the directors and officers of an advertising agency, on leav-

ing the corporation's employ, could not take with them agency accounts and corporation employees, under penalty of recouping the corporation for its damages and lost profits.

In a stockholders' suit brought against the president of the D. & C. Navigation Company, the suing stockholders charged—and the president denied—that he had made secret profits in the purchase of a truck line company by the corporation.

§ 246. —— Competition with Corporation.

A director may not directly or indirectly compete with his corporation. Any profit accruing to the director by reason of such a relationship is forfeit to the corporation.

The situation last cited is an example of this disability.

Likewise, in a suit brought by trustees of a defunct radio company against a former president and director, the latter was required to pay some $70,000 realized by him as profits in a competing business.

A director of a company seeking orders for shipments abroad was held disqualified from seeking to fill such orders with materials in which his company dealt, purchased from domestic competitors.

§ 247. —— Conflict of Interest Generally.

By acceptance of the post, a director impliedly pledges himself to avoid any detriment to the corporation by reason of a conflict of its interests and his. On occasion such a conflict arises despite anything a director can do and its settlement necessitates a sacrifice of the director's personal interests. However such a

resolution may work a personal hardship on the director, that must be the solution; only thus can the director satisfy his fiduciary obligation. This is the director's disability.

An example of such hardship to a director was found when, encouraged by the president, the director sought to find purchasing sources for the company's products in foreign countries. The director procured and accepted orders for delivery in France and then a corporation which had been acting as the corporation's foreign agency objected to the corporation's filling the director's order, threatening to terminate its agency agreement if the corporation did so. The matter then being brought to the attention of the board of directors, the latter found that the general agency agreement had produced considerable foreign business to the corporation and promised to continue to do so. Though the director contended that the corporation was legally obligated to fill his contract, the board maintained that he could not insist upon its so doing since the result woud be to cause the corporation to suffer a termination of its advantageous general agency contract with consequent loss to the corporation; a consequence the director was bound, by the obligations he had assumed in accepting office, to vote to avoid. The situation was worked out by having the general agent assume the director's contract; the corporation filled the order; the director suffered a loss of what would otherwise have been his profit.

§ 248. Disqualifications.

§ 249. —— Generally.

Disqualifications are frequently more practical than

legal, sometimes partial or temporary, sometimes recognizable and cognizable, often abstruse and latent to an extent that does not constitute disability. These may involve matters such as those of temperament, previously discussed, of conflicting or other business interests; even conflicting social or communal conflicts may arise to create duality of a director's obligations. Where, for example, preferred stockholders' control of a board is called for because of dividend defaults, a common stock interest may constitute a director's disqualification. Similarly, an adverse creditor interest, where there is a possibility of clash between creditor and stockholder interests, or where insolvency is threatened or present, may constitute a practical and recognizable disqualification. In some of these situations, proprieties rather than legalities may be the testing ground, for example when a local resident is called upon to pass upon the question of abandonment of a company plant that may affect the business interests of the town, and of himself, or of his neighbors and friends.

§ 250. —— Legal.

In an earlier chapter, we pointed out the slight legal qualifications ordinarily prescribed for the director. We there referred to special statutory requirements, the effect of which are not so much to add qualifications as to impose disqualifications.

A person who is disqualified to act as a director may be said to be disabled to act while his disqualification persists.

Instances of legal disqualification are found, for example, in the Interstate Commerce Commission Act and rules that prevent interlocking railroad directors,

in the SEC Utility Act which prohibits interlocking utility directors and delimits service on utility boards of bank directors, the Commerce and Trade Act, prohibiting interlocking bank directors and interlocking directors of large corporations engaged in competition with one another. State statutes impose disqualifications in special instances; for example the New York State Insurance Law disqualifies as a director a person who has been convicted of a crime involving fraud, dishonesty or like moral turpitude or is found by the Superintendent to be "an untrustworthy person."

In a suit brought by the Government, a federal judge found a director of Sears Roebuck, who also served on the board of the B. F. Goodrich Company, entitled to hold only one of such posts since he found the two companies competitors and the interlocking directorships violative of the antitrust laws.

In this category is the suit previously mentioned, brought by Hamilton Watch Company which thereby prevented the Benrus Watch Company from obtaining representation on the Hamilton board because of Benrus' competitive position. Also to be noted that when Avery of Montgomery Ward charged that Wolfson, seeking a place on the Montgomery board, was disqualified because he was a director of a competing corporation, Wolfson resigned his conflicting directorship.

CHAPTER XV

Directors' Liabilities

§ 251. Generally.

To the extent the director is charged with duties, he finds himself subjected to possible liabilities for their breach. Similarly, when he disregards disabilities or disqualifications, he subjects himself to similar danger.

Since, as we have pointed out, directors' duties imposed by statute or by the fiduciary obligations involved in the care of the corporate assets call for performance by the director himself, they constitute the most serious potential sources of liability.

§ 252. Statutory Duties.

We referred previously, in some detail, to the duties expressly charged upon the directors by the statutory law. These, of course, vary with the state statutes

themselves. Generally, however, as pointed out, they involve formal corporate matters such as go to the capital structure of the corporation, the issuance, increase and reduction of its capital stock, to basic corporate changes such as merger, dissolution, to selection of officers and declaration of dividends. A failure to observe the particular statutory dictum may readily subject a director to liability to stockholders or creditors.

Obviously, a director cannot be expected to familiarize himself with the requirements of applicable state and federal statutes. He must necessarily depend on company counsel for protection when a matter involving basic corporate changes comes up for consideration. However, he cannot permit himself to remain wholly ignorant of general principles which generally underlie the mores of these statutory principles and prohibitions. For that purpose we discuss the more important matters briefly.

§ 253. —— Capital Impairment.

Generally, state statutes seek to protect creditors against improper reduction by directors of the corporate capital needed for creditor security and payment. Buying in stock when no funds are legally available for the purpose is such a violation, although a director who acts in good faith relying on corporate records may be exculpated from such liability.

§ 253a. Dividends.

Statutes invariably seek to confine the declaration of dividends to moneys available from earnings. In any event, they seek to prevent the impairment of the corporate capital through the payment of dividends.

Conscious of the dependence of directors upon the accounting officers, the law in most states exculpates directors from responsibility for the payment of illegal dividends if, in declaring such dividends, the directors have relied, in good faith, upon certification of the proper officers or accountants that funds were legally available for dividend purposes beyond any statutory or contractual restrictions. Failure to observe statutory and contractual prohibitions, in the absence of such assurances, however, generally will subject the directors voting such dividends to liability, and, in some cases, statutes make that liability criminal, as well as civil.

§ 253b. Examples.

For example, an Arkansas court held directors liable personally to pay the deficit of a creditor's claim when the directors permitted the corporation to commence business before its stated minimum capital had been paid in.

A violation of a capital representation subjected directors to liability in another case where a rather large mortgage venture was conducted during an active real estate market period by a half dozen stockholders acting through their corporation. When the real estate market began to turn sour, the corporation found itself in a liquid cash position and the stockholders decided to terminate the venture. However, they thought it wise to keep the corporation alive, awaiting a possible resumption of real estate activity. So, under guidance of counsel, the directors paid all the corporate debts and divided the cash assets between the stockholders.

However, one parcel of real estate remained and for the next few months the directors tried, without avail,

to sell it. Then one of the directors got the bright idea of mortgaging it, which the corporation did. When the first installment of interest on the mortgage came due, the corporation defaulted, as it had intended to do when it placed the mortgage. As the wily director put it to the mortgagee: "You didn't know we were selling you the property for the price of the mortgage, but we were."

The mortgage was foreclosed and the mortgage holder bought in the property, without competition, for a nominal sum. Because of this, he got a deficiency judgment against the corporation for practically the full amount of the mortgage. When the mortgagee's lawyer tried to collect the judgment from the corporation he learned the facts concerning the distribution of the corporate capital to the stockholders. Incidentally, the money the corporation had received on the mortgage had long since been used up for "expenses."

The mortgagee's lawyer then sued the directors and stockholders of the corporation to require them to repay to the corporation the corporate cash that had been distributed to them, so that he could collect his judgment from such funds. And following the service of the complaint, the judgment was paid. Why? Because though company counsel had advised the directors that so long as all creditors were paid, they could reduce the capital and the capital stock by distribution of assets to stockholders, he did not follow that up by filing a certificate showing such reduction in the Secretary of State's office, as the law required.

But his client asked the lawyer: "What difference did that make? We had no creditors then; we'd paid

them all off. This mortgagee did not become a creditor until months later."

The client and the company lawyer discovered, to the lawyer's discomfiture and the client's loss, that the law assumes that before one extends credit to a corporation, he looks it up in the Secretary of State's office and ascertains the amount of its paid-in capital. The creditors, the law says, then or later, are entitled to rely upon the corporation having the capital shown by the papers filed in the Secretary's office, whether they look at them or not. So notice of reduction of capital must be filed or the stockholders cannot keep the money they receive when reducing capital and capital stock, even as against a later corporate creditor.

§ 254. —— Issuance and Sale of Securities.

Various of the states and federal government have statutes which regulate the issuance and sale of securities by corporations. The state laws are known as blue-sky laws; the principal federal statute is the Securities Act of 1933. These statutes are a source of potential director liability.

The Federal Act requires a corporation issuing securities offered for sale, which are not expressly made exempt from the operation of the Act, to file a registration statement with the SEC. This must be signed by a majority of the directors either personally, or through agents designated by them. The Act charges the directors with possible liability for false and misleading statements.

§ 255. —— Trading in Securities.

We pointed out disabilities under which the director

operates in buying or selling the securities of his corporation. Aside from liability generally which may flow from their breach, specifically it may properly be repeated here that a short-term profit that accrues to a director as a result of such trading is payable to the corporation and that the corporation or a stockholder on its behalf may recover such profit from him.

Otherwise a director may buy and sell the corporate securities, provided he does so fairly and in good faith. However, if, as noted, the corporation seeks to buy in bonds or preferred stock for the purpose of anticipating redemption at a greater price, a director may not compete with the corporation, or, without disclosure to stockholders acquire their stock, in an effort to make a profit for himself.

§ 256. —— Particular Corporations.

In addition to state and federal statutes of general application, we find statutes referring to particular types of corporations, such as banks and public utilities, or to particular situations involving loans or competitive relationships. So banks or insurance company directors are generally prohibited from receiving compensation, directly or indirectly, in connection with loans made by their corporations, while banks and insurance companies are forbidden to lend to one borrower more than a certain percentage of their capital. Whether directors violate the prohibition directed to them or participate in an act forbidden to their corporation, they may become equally liable, and, on occasions, not only civilly but criminally.

§ 257. —— Insolvency.

Other frequent examples of statutory prohibitions directly affecting directors are found in cases of threatened or actual insolvency, when potentially or actually the rights of creditors may be jeopardized. In such cases, for example, a director may be subjected to personal liability to creditors for dividends declared or claims paid to one creditor in preference to others.

So penally do courts think in connection with insolvency that we find a court holding directors personally liable when, though without fraud, they caused an insolvent corporation's assets to be sold at public auction without notice to creditors and less than the fair value of the assets was realized.

§ 258. —— Ultra Vires and Other Illegal Corporate Acts.

As previously indicated, it is not necessary that a statute or rule of law be aimed directly at a director to charge him with liability for its violation. If a director participates in an act forbidden to the corporation by law, he may be subjected to personal liability for such violation. So a director who knowingly participates in a corporate loan or guaranty forbidden to the corporation may find himself subjected to personal liability for the losses thereby sustained by the corporation.

Consequently, a director should beware of being a party to price-fixing agreements, consolidations or mergers in restraint of trade, or tax evasions—as opposed to legitimate tax avoidances. He should not sanction summary refusal to grant stockholders their legal rights of inspection of books and records—which frequently carry with them penalties—or knowingly

wink at law violations. "Fixing" inspectors, "purchasing" revenue agents, black market violations, illegal cartel arrangements, breach or evasion of the regulations of supervisory bodies, covering unwarranted expenditures by charging them to other accounts, or otherwise having false entries made in books, come in the forbidden categories.

Where any intimation of such practices is found at the directors' table, a director should not take the risk of becoming a party to them by inaction. On the contrary, his instincts of self-protection require him to rise to the occasion and have his active and affirmative dissent recorded. Common sense, as well as the law, will impute certain notice and knowledge to a director and he cannot always escape such conclusions. Besides, where a statutory liability is involved, the penalties may be criminal as well as civil.

§ 259. Care of the Corporate Property.

Many of the statutory requirements and prohibitions to which we have adverted are largely aimed at charging the directors with fiduciary care of the corporate property. These statutory rules are supplemented by the trustee requirements of the unwritten judicial—the substantive—law.

The two basic requirements of the latter, as previously noted, may be summed up as requirements for (1) honesty and (2) diligence.

§ 260. —— Disabilities.

The honesty requirements are largely found in those which previously we listed as "disabilities." Disregard of these disabilities bring into play consequent liabili-

ties. So, as previously indicated, a director may become liable for the corporate detriment caused by his personal competition, or his appropriation of its assets or opportunities, or his otherwise subordinating the corporate to personal interests.

Such a misapplication of funds was found when directors had their bank make a loan to corporation "A." With the funds, corporation "A" bought control of corporation "B," which was owned by some of the bank directors and officers. Still using the funds provided by the bank, corporation "B" paid off illegal loans previously made by the bank, in which borrowings the officers and directors were interested. When the bank went broke, the directors and officers who handled the transactions were held criminally liable.

So, too, the directors may be liable for acts which they affirmatively authorize or knowingly permit if they result in diverting or wasting the corporate assets.

It is rare to encounter disclosure such as occurred when the former president of Colonial Airlines was fined in a criminal proceeding for falsifying company records and the prosecutor said: "He was a grasping, ruthless promoter who charged on the company's records bills for his food, liquor, personal gifts, pleasure boats, a Bermuda home, servants abroad and his apartment."

Examples of diversion and waste were furnished by a judgment rendered against the president of a defunct radio company who was required to repay moneys represented by excessive salaries and profits through unjustified stock options and personal obligations shifted to the company.

Examples of waste were furnished by an opinion of

the Interstate Commerce Commission charging that members of a railroad management had paid themselves "inordinate, extravagant and wasteful" salaries, expenses and fees, had expended excessive amounts for extravagant entertainment of officers and customers, had made noninterest bearing loans to officers and had used railway funds and resources in stock speculations.

§ 261. —— Diligence.

Directors' liability may arise not only when they have profited by their breach of duty but also when the corporation has suffered loss by reason of their negligent acts.

For example, a bank board—where the law eyes the directors stringently—authorized its bank to buy a block of bonds at a price under the market, and to give the seller a six months' option of repurchase. The bank sustained a considerable loss on the purchase and the court charged the directors with the loss, saying the transaction was improvident, risky, unusual, unnecessary, and contrary to fundamental concepts of prudent banking.

The director's duty may include the exercise of diligence when he sells his stock and transfers control of the corporation. Here it must be remembered that when directors are vested by stockholders with control of the corporation they become fiduciaries and may not blindly vest that control in strangers.

So, where a group of irresponsible persons offered to purchase the directors' controlling stock of an investment trust owning securities, provided the directors would resign and put the purchasers in control of the

corporation. The purchasers had no money but they succeeded in inducing a reputable banking firm to make them a very temporary loan sufficient to cover the price of the stock. Simultaneously, they (1) had the lender turn over the check for the loan to the selling directors, (2) had the selling directors resign and install the purchasers in their places and, finally, they took from the treasury of the company securities of sufficient value to repay the loan.

This sequence of simultaneous events translated these exponents of truly-free enterprise from freebooters, with no funds, into stockholders, directors and officers of an investment trust with a "looted" treasury. Concurrently, it converted the former stockholders, directors and officers of the investment trust into what in effect were receivers of the proceeds of securities stolen from the corporation. And it impaired automatically and materially the value of the outstanding stock of the investment trust held by the public.

The court ultimately unraveled the tangled web, as best it could, by criminal prosecution of some of the "free-riders" and by civil penalties fastened upon the directors who had sold control.

The question posed, when the director is not charged with an attempt to personally profit, is not always easy of resolution. Two examples will illustrate.

A corporation was undergoing reorganization. Its counsel presented a plan of reorganization simple in its essence. It was based on the theory that the corporation owned a large tract of mineral-bearing lands that it was holding for future development but for which it would have no use for at least fifty years. As counsel properly said to the court: "Our annual taxes on this

tract of land amount to 3% of its value. In the next fifty years, during which we will have no practical use for the minerals in this land, we will have to pay 150% of its value. So why should we not get rid of this land now and save the annual taxes of three million dollars a year for the next fifty years?"

The proposal, of course, met with unanimous and unqualified acceptance and the corporate reorganization was effected on this basis and converted an insolvent and moribund concern into an active and successful one.

But, curiously enough, no one asked the obvious question: Why did the directors neglect to take this obvious step ten years before? Then they faced not fifty, but sixty sterile years. Then the prospective cost of holding the barren lands was not 150% but 180% of their value.

If the problem and its solution were obvious at the time of reorganization, they were equally simple ten years before. If the need was urgent during the reorganization, it was all the more cogent a decade before.

Nevertheless, for the ten years preceding the reorganization, the directors of the corporation had done nothing about the obvious waste of the corporate assets. Instead, they permitted the corporation to continue the useless expenditure of three million dollars a year in avoidable tax payments. Had the directors been alive to their jobs, the corporation would have had thirty million dollars in cash in its treasury, and it would not have had to knock on the door of the reorganization court and ask admittance. But when it did, and when later, shriven, it emerged through the same portals, this nonfeasance still lay buried in the same judicial files.

In another case, stockholders sued directors of a large industrial corporation alleging, in effect, that because the head of the concern was a notorious labor baiter who hated unions and the National Labor Relations Act, he had persuaded or forced the directors to close up an otherwise profitable plant for the purpose of "taking it out" on labor and showing employees "what was what." The stockholders sued the directors to recover the loss they claimed the corporation had thereby sustained.

The court held that these claims, if true, would furnish an example for any one—and almost all—of the improper legal practices we have just mentioned—a waste of corporate assets, a misapplication of corporate property, using the assets for unlawful purposes. It held such claims, if proved true, would subject the directors to liability on all counts. However, at that point in the litigation, the court was not considering any evidence for none had yet been submitted. It was merely passing on the theoretical question of whether such charges, if true, would violate legal standards for directors' conduct and it held that they would be actionable.

Obviously, if there was any truth in the charges, the directors would be marked, not as dishonest—no element of personal gain could be involved—but either as inactive, acquiescent, or unknowing. The latter conclusion would probably be the most logical, for until the final court had spoken in this case, no cautious lawyer would have ventured to risk a definite opinion on a prediction of the result. Yet, where the legal territory was so virgin, a cautious director would—and should—refuse to venture.

§ 262. Managerial Duties.

When we pass to the performance of the directors' managerial and stockholder representative duties, we find the law more tolerant in the standards of performance it seeks. Here the law remembers that it is charging the directors with duties they are expected to delegate to others, with duties not classed as fiduciary.

So here, the law does not require that the director bring to his managerial and representative tasks any special qualifications or particular abilities or energies. But when he takes on the job (1) he must give it reasonably diligent attention; (2) he must bring to bear upon it the fair degree of such skill and judgment as he possesses and would devote to his own affairs, and, of course (3) he must be honest.

§ 263. —— Negligence.

Of this branch of duties, the tangible basis of liability is the negligence of the director. In practical effect, his negligence must be reasonably gross, something more than an ordinary lack of reasonable diligence. Basically, in the absence of a specific situation that arouses the wrath of a court, the director must be proved a "dummy," in the true sense of the word.

"The law has no place for dummy directors," a noted judge said, with unjudicial terseness. And other judges have said in substance that no agreement or understanding with stockholders or management, that no excess of confidence in the executives, will afford an inactive director protection from civil personal liability when things go wrong.

The legal indicia of the dummy director is a failure to attend meetings, a failure to examine reports and

records, a failure to keep himself advised, by inquiry or otherwise, of general conditions, a failure to do anything about conditions brought to his attention, or of which, had he been active, he would have learned. These are fundamental duties of a director. And a failure to perform them brands the director as "window-dressing," a "dummy," or a "rubber stamp."

Manifestly, a director may really rank in one of these classes although he may attend meetings and make routine inquiries. His closed mind rather than his inattention may mark him for a "marionette." However, while the legal conclusion of neglect might, on occasion, be the same, the measure of legal proof would be more difficult to fill. Physical inactivity, however, is positive and conclusive.

Even where, concededly, a director has paid no attention to his job, he can be charged with no personal liability unless, first, damage has resulted and second, it has resulted from his carelessness. So, if a director fails to attend meetings and pays no attention to the corporate affairs and the business fails, the director is not liable to the stockholders for their losses unless it appears that if the director had been on the job, the losses would have been avoided.

Several actual cases furnish example and contrast. In one, a director who lived at a distance from a small Western bank had so much confidence in the two officers of the bank that he left its management entirely to them, attended no meetings and sought no reports. Later it appeared that the officers had mismanaged the affairs of the bank, had made improper loans and otherwise had caused it loss. The director was held personally responsible for the loss, the court holding that

had he given his attention to the affairs of the bank, he would have discovered the mismanagement in time to have halted it, and the bank would thereby have avoided the loss.

In the case of a large New York trust company, the president, managing officers and some of the directors committed the bank to a long series of statutory offenses, improper and unauthorized loans, unauthorized investments, nepotism, and the like, over a considerable period of time. The Appeals Court sent the case back to the trial court, saying that since the defendant never went near the bank, knew nothing of its affairs and gave no attention to its business, there seemed to be ample evidence of his neglect, but that the factual question remained to be determined, whether the director's neglect caused the losses or whether they would have been avoided had he been diligent.

As against these, there was the case where the treasurer of a corporation had been embezzling for years. Yet, when an attempt was made to hold a negligent director liable for the loss, the court refused to do so, holding that the treasurer's defalcations had been so cleverly concealed that, even if the director had been diligent, he would not have discovered them; and that the corporation would have suffered the loss anyway.

We said a while back, that a director who faces a charge of negligence has only himself to blame. Perhaps this ought to be qualified. Even an active director needs to be cautious at times.

It is not unusual for management to deliver financial reports to directors, which are so voluminous, technical and intricate, that even a conscientious director is inclined to give them a glance and toss them aside. Nor

is it unusual for management to report so briefly at a meeting concerning some technical situation that the facts are hardly grasped by the directors. Nevertheless, a note of such report is invariably carried in the minutes, which may not indicate the casual or brief nature of the information supplied.

These practices are unfair to the director. A report received at a meeting, verbal or written, imputes to and charges a director with the information it contains or may be said to contain, even though the director gave it but passing attention. It may not be true that a director need fear consequences from such isolated occurrences; but it is a fact that any such regular practice holds germs of danger and should meet with prompt rebuke from vigilant directors.

Regular monthly financial reports, as has been said before, should be compressed and their form should promote understanding, not only that a director may get what he needs from them in order to do his job, but so that he knows what he is being told, for his own protection.

In most cases of negligence that reach the courts, when the question is raised whether a director's lack of admitted negligence might have avoided the loss, it is frequently argued that had he been present at a meeting some report, verbal or written, would have jogged him to attention. This is what is meant by an "imputation of knowledge." Such imputation crops up continually in these cases of directors' negligence and emphasizes the need for not ignoring reports, verbal or written, tossed on the directors' table.

Another facet of this subject has been discussed previously. We pointed out that the greatest legal pro-

tection for a director lay in exercising his judgment. The law, like the Church, will forgive his honest mistakes, though it may require monetary atonement if he fails to exercise his judgment at all. And we might add here that the question of whether he really used his judgment, or was actuated by some ulterior motive, is a factual question for a judge or jury to decide. However, the statement that the law forgives the director for his error of judgment does not mean that he will be forgiven for management's error of judgment.

The distinction is simple, though important. A textile concern operating a series of mills has one in New England. Other concerns in the industry move their mills South for better labor and operating conditions. However, the executives of this corporation think conditions in New England will change, so they go on operating there and losing money on the New England mill over a period of years. Ultimately, stockholders sue the directors for the loss, saying the directors saw these mounting losses each year and did nothing to stop them, though other concerns in the industry had shifted losses to profits by moving South.

Such a situation finds the directors in a fix. Had they been moved by the monthly and annual statement of losses to consider the question and make their own investigation, they might have concluded to move—and the losses would have been avoided. Or they might have decided to stay, and though the losses continued, they could now say to the stockholders: "We are not liable; we were guilty only of an honest mistake of judgment." But they cannot say this because they did nothing but accept the management's judgment. And in a situation such as this, the management's judgment is no substi-

tute for the directors' judgment—and no answer to a charge that the directors were guilty of neglect in not employing their own independent judgment.

A potential of directors' liability was disclosed when the annual report of a fairly large company was issued, signed by only two directors, which said that the unusual method of issuance was adopted because the other directors and principal officers of the company might be in some measure involved in corporate tax evasions, the result of which might be corporate penalties. Manifestly, the situation thus disclosed carried with it the seeds of directors' liability for penalty losses suffered by the corporation, in consequence of the illegal acts, either on the basis of personal implication or personal negligence.

To conclude this phase of the subject of directors' liability we might illustrate not only a case of proven negligence, but also our previous statement that the subject is one that is not free of judicial doubt.

In a suit brought in the New York Federal Court, a corporation had gone into bankruptcy and the receiver sued a director to recover corporate losses upon the ground that he had been negligent in not taking action to prevent them. After hearing the evidence, the judge found that the director had taken the post because he was a friend of the president, that after he had taken on the job, he had done nothing to inform himself concerning the condition of the business except to talk to the president now and then when he met him on the suburban train they both took in the summer time.

The judge concluded that the director had been negligent in not making adequate inquiry and found that had he made such inquiry he would have been bound

to do something to stop the losses the corporation had continued to incur. Therefore, said the judge, the director was liable to pay to the receiver the losses suffered by the corporation.

In his opinion, the judge characterized the decisions on the subject of directors' negligence as vague. He called attention to a case decided by the United States Supreme Court in favor of directors by a six to four vote, and said that today the decision would probably go the other way.

§ 264. Suits to Enforce Liability.

The question of a director's liability ordinarily is a symptom either of corporate insolvency, when creditors or their legal representatives seek to remedy the corporate deficit, or the consequence of factional disputes within the corporation, internecine management controversies or proxy contests, when bitterness becomes the catalyst for airing grievances.

The civil liability of a director is usually established in a suit brought either by the corporation, by its stockholders, or by a receiver or trustee appointed for the corporation where it has come under the jurisdiction of a court.

When a director's offense is grave and individual, as, for example, in a "secret profits" case, it is not uncommon for the other directors to authorize the corporation itself to bring the suit. In isolated cases, where the board splits on such a question, one or more members of the board may be found exercising a director's prerogative to bring the suit on behalf of the corporation. And this they may do without the various restrictions upon stockholders to which we refer in a moment.

In other cases, particularly where a number of board members are involved, and particularly where the offense is technical, the directors usually take no action. In those cases, stockholders who learn the facts may demand that the board bring an action. And, if the board fails to do so, the stockholders may institute an action themselves. This is known as "stockholders' derivative suit" and has been the cause of much controversy in recent years.

The common example of directors' refusal to bring a suit is found when the directors themselves have been guilty of the misconduct of which the stockholder complains. Then the stockholder has an obvious right to disregard the directors' failure or refusal to bring suit and he may institute it himself for the benefit of the corporation.

A derivative suit, it might be remarked, when brought by a stockholder, is pressed on behalf of the corporation. Any recovery in the action, less the suing stockholder's expense—principally lawyers' and accountants' fees—which are allowed by the court out of such recovery, goes to the corporation and becomes part of its general assets.

The legal theory behind such suits is readily discernible. The stockholders are supposed to elect the directors and the directors, on behalf of the stockholders, are expected to check on the management. If the directors are lax or recreant, through the medium of a stockholder's suit, a court on behalf of the stockholders can review first, the failure of the directors to bring the suit, and then, if the directors are found to be at fault in this, the court will review and act upon the transactions of which the stockholders complain.

Stockholders' suits, on occasion, are effective. There have been many recoveries and, though small in number in comparison with the widespread scope of our corporate activities, they were supplemented by a large number of settlements—"buy-offs." Some of the recoveries have run into many millions of dollars and the publicity these large recoveries received have had a prophylactic effect on directors who otherwise might have felt immune from supervision and retribution.

§ 265. —— Denial of Remedy.

Board members are ordinarily under no liability if they fail to respond to a stockholder's demand to bring a suit. They may, in the exercise of their discretion, believe that a suit is not warranted. And, in a proper case, this may be so even though the corporation could recover if it sued.

There are conceivable situations in which a corporation, standing on its legal rights, suing and recovering, might lose more in good will and future business than it could recoup by asserting its legal claim. There is hardly a business man who, at one time or another, has not let an otherwise good customer "get away" with something rather than antagonize him by insisting on winning an argument. A board frequently must exercise a similar judgment, and when it does so, honestly and independently, its decision will be respected by the courts.

A striking example of this is found in a comparatively recent case. An officer of a large motion picture company paid notorious labor racketeers a big sum of money to avoid a threatened unjustified strike. When the stockholders heard of this, they claimed the payment

was illegal and unjustified and demanded that the corporation sue the officer for the return of the amount of the "bribe money." The directors refused to authorize the suit by the corporation, so the stockholders brought a derivative suit. The court threw the stockholders' suit out, holding, first, that the officer did not "bribe" the racketeers but submitted to their extortion because he thought the interests of the corporation required it and, second, that this was legitimate use of the corporation's funds and a matter concerning which the directors might use their discretion, not only in authorizing or ratifying the payment, but also in suing or not suing to recover from the officer the money he had thus paid.

Within recent years the law has been changed in a number of states to forbid small stockholders from bringing suits to recover corporate losses unless the complaining stockholder puts up a bond to cover the defendant's cost of defending the suit. Since such costs include prospective attorneys' fees, the amounts called for in such bonds are usually prohibitive, and small stockholders' suits are in effect barred.

§ 266. Directors' Liability for Failure to Sue.

There are times when a stockholder discovers cause for a suit too late for him to enforce the corporation's right to recover. The technical reason for this is found in what the law calls the "statute of limitations." This is a legal proviso that says that a suit must be brought within a given number of years, else it may not be brought at all. The obvious purpose of this is to prohibit the attempted enforcement of "stale" claims at a period when, through passage of time, it may no longer be possible to find witnesses or locate records.

When directors neglect to bring a justifiable suit on behalf of their corporation within the period the law permits, they may become liable to the corporation for the loss it has suffered in consequence. Here, the directors may be found guilty, either of negligence or of a deliberate waste of corporate assets. And a stockholder may, in a proper cause, bring a suit against the directors to enforce their liability in this regard.

In one case in New York, a large corporation "settled" a suit brought by stockholders against directors. The settlement took the form, once quite usual, of "buying off" the plaintiff stockholder. Such "buy-off" is accomplished by having the corporation buy the complaining stockholder's stock for a sum of money largely in excess of its market value and by paying his lawyer's bill. The total cost of this particular "settlement" came to a half-million dollars. Some time later, another stockholder brought a suit to charge the directors and officers for the half-million dollars improperly paid out by the corporation in "settlement" of the first stockholders' suit. And the court rendered judgment against the directors for the amount in question.

§ 267. Directors' Indemnity.

In an effort to alleviate the hardships of directors who were subjected to unsuccessful or unjustified stockholders' suits, some states adopted laws that permit a corporation to indemnify directors against loss arising from payment of counsel fees and other expenses, in unjustified suits brought against directors by complaining stockholders. However, it is to be noted that these statutes do not permit the corporation to pay the judgments recovered when directors are found re-

miss. Those penalties must be borne by the directors themselves.

§ 267½. Summary.

Directors' disabilities and disqualifications are not imposing. With rare exception they offer no difficulty to the conscientious man of average ability who is prepared to bring to his task the abilities with which he has been endowed and a basic recognition of the trust obligations he assumes. The law requires no more.

PART II

The Corporation

Introduction

The corporate scheme is no modern invention, if the term is employed to designate its root structure. Though the Greeks had societies of a sort, according to Sir William Blackstone, "the honour of originally inventing these political institutions entirely belongs to the Romans." It was they who, with the conquest, carried the corporate concept into Britain; however, the English, again according to Blackstone, "considerably refined and improved upon the invention, according to the usual genius of the English nation." The early Roman corporations were largely political and ecclesiastical; it fell to the English to extend the scheme of association as means for the advancement and regulation of commerce, exploration and manufacture.

It is not generally realized that, nevertheless, our present system of free competitive and corporate enterprise for private profit is of comparatively recent development. The Romans viewed with distrust attempts to avoid individual responsibility and forbad the creation of industrial corporations. The European industrial guilds sought to restrain and limit competition rather than to promote individual enterprise and speculation. Even in the American colonies—in Boston to be exact—as late as 1644, Robert Keane was fined for making an excessive profit in a commercial transaction.

However, during the middle ages, as the gathering forces of the economic revolution made inroads upon

European feudalism, as the desire for personal profit began to fall into the outlines of a way of life, the corporate scheme began to emerge as a vehicle and associations were organized for foreign adventure, exploration and colonization, for the exploitation of commerce and trade. The Dutch East Indies Company was one of the best known of these companies. The Hudson's Bay Company, incorporated in England on May 2nd, 1670, under royal charter, as The Governor and Company of Adventurers of England Trading Into Hudson's Bay, survives in modern form and is reputed to be the world's oldest continuing commercial enterprise.

The dominant English financial interests sought to discourage independent corporate organization in the American colonies prior to the Revolution; immediately thereafter, the freed spirit of America initiative sought the advantage of the corporate form and state legislatures, commencing in 1781, began to charter companies for manufacturing, land exploration and development, for the creation and maintenance of turnpikes, canals, bridges and the organization of commercial banks.

Naturally, as with most ancient devices, these early associations were rude concepts as compared with today's corporate assemblies. And it is this very growth of corporate power that creates today's inadequacies of regulation and control and commensurately carries with it a host of responsibilities shared by executives, directors and stockholders alike.

As with any work of art, the modern corporation—and it is entitled to be so designated—varies with the eye of the observer.

In the eyes of the stockholders, it is a business for investment or speculation; in those of the executives, it is a job. As the directors view it, it can be a job of work or a mere badge of prestige.

For practical purposes, the legal concept of a corporation may be said to be an association of investors who band together to conduct a business enterprise for their own private profit. The corporation owns the assets and owes the debts; legally and factually, the shareholders are the beneficial owners. As such owners, the stockholders are entitled to make the rules governing its operations and affairs within the limits of the privileges granted them by the state.

Since stockholders, like a body of citizenry, cannot govern directly, the law provides that they shall govern the corporate affairs through representatives of their choice, directors, sometimes called managers or trustees. In turn, since directors are elected to manage but not to operate the corporate business, the actual conduct of operations is entrusted to agents they appoint as officers of the corporation. Some of these, the principal executive officers, are appointed by the directors, others, the subordinate officers, by the principal executives.

Thus we find the democratic scheme of corporation control and management, as conceived and provided by the law. Except as it recognizes the dollar as the unit of vote, it is in essence the political scheme provided for the conduct of our political affairs.

Contents

§ 268. Defined.

A stock corporation, sometimes known as a business corporation (as distinguished from nonprofit corporations—with which we are not here concerned) is a voluntary association of stockholders enfranchised by the state to engage in business for private profit.

§ 269. Organization.

Corporations are authorized by and organized under the laws of the various states, of the national government or of foreign governments.

§ 270. Laws Governing.

The rights, privileges and duties of corporations, their directors, officers and stockholders, are determined by the laws of the political body by which they are empowered to organize and of the jurisdiction in which they do business.

The necessary obeisance by a corporation to the laws of several states may become a matter of no small difficulty since, with the exception of two states, Idaho and Washington, which have adopted what is known as the "Uniform Stock Corporation Law," the corporate laws of no two states are alike.

§ 271. —— Special State and Federal Laws.

In addition to these varying state corporation laws, many of our corporations find themselves subject to

additional rules and regulations found in special state and federal statutes. Such corporations are usually those engaged in a business charged with a special public interest.

§ 271a. Corporations Charged with Public Interest.

So, for example, we find banks, trust companies, investment, savings and loan, mortgage guaranty, public service, traction, railroad, omnibus, electric light, gas, water, bridge, toll road, mining, oil, and other companies, which come into the public domain, and accordingly are charged with special duties and obligations under appropriate special laws of the state in which they are incorporated or in which they are found doing business. Many are also regulated by federal statutes and agencies.

§ 271b. Stream of Interstate Commerce.

In addition, today, with constantly growing federal centralization, all companies must give heed to federal controls and regulations. These frequently come into play as a result of the nature of the corporation's business, i. e., when it is tinged with a public interest, or the manner of conducting it, i. e., when its business is interstate, i. e., lies in the "stream of interstate commerce." Incidentally, this invisible "stream" reaches incredible and far flung places.

Examples of corporations subject to federal laws by virtue of the nature of their business include national banks, railroads, air lines; federal regulation affecting the manner of conduct of business by interstate or intrastate companies are legion.

For further example, trust companies, and other com-

panies that undertake to act as trustees, are subject to the Federal Trust Indenture Act of 1939. Stock brokers, national security exchanges, and corporations with stock listed on such exchanges, are subject to the Federal Securities and Exchange Act of 1934. Corporations which seek to sell stock, not otherwise exempt, must comply with the provisions of the Federal Securities Act of 1933 in addition to complying with state "Blue-Sky" regulations. Many public utility companies serving gas and electricity must heed the injunctions of the Federal Public Utility Holding Company Act of 1935 and the Federal Power Act.

Cursory investigation will disclose a wealth of other federal regulatory statutes, each with its special corporate applications. In this category, we find the Interstate Commerce Act, the Federal Civil Aeronautics Act, the Investment Act of 1940, the Investment Advisers Act of 1940, among others, to say nothing of federal statutes of general application, such as the Clayton Act, the Sherman Anti-Trust Law, the National Labor Relations Act, and the ubiquitous tax law. Many of these statutes are supplemented by a host of rules and regulations adopted by the federal agency charged with administering the act.

Obviously, the intricacies and technicalities of these laws are far beyond the understanding of any businessman. Indeed, the average lawyer cannot unravel many of their ambiguities without the aid of a specialist, who, frequently, is an ex-employee of the agency which administers the act.

§ 272. —— National Corporations.

In addition to state organized corporations, financial

corporations may be found incorporated under federal laws. In this class are private business corporations, such as national banks and savings and loan associations. Governmental or semi-governmental agencies are also organized as corporations, such as the Reconstruction Finance Corporation, the Home Owners Loan Corporation, and others of like governmental purpose.

§ 273. —— Foreign (Non-U. S.) Corporations.

For tax or other reasons, corporations whose securities are held by American investors and which are listed on American stock exchanges are frequently organized in foreign countries, Venezuela, Mexico, Panama, Cuba, Canada, being current and frequent examples. Such corporations may or may not do business in this country; nevertheless their securities may be traded in here.

However, since these corporations are not engaged in business in the United States and may have no property here subject to attachment, they cannot be sued here; they must be pursued in the country in which they are incorporated or in which their property is to be found; and such suits will be governed by the laws of the country in which the suit is brought.

Any lawyer or businessman who has had occasion to pursue some of these foreign corporations into their domiciles knows the difficulty and generally the futility of so doing; and this is particularly true when American investors seek protection in the reorganization of such companies under their domiciliary laws.

§ 274. Power to Conduct Business; "Domestic" and "Foreign" Corporations.

A corporation is authorized to conduct its business

within the territorial limits of the state in which it is organized; it may conduct business in other states but only by also complying with their laws. In the state of incorporation it is known as a "domestic," in other states, as a "foreign" corporation.

§ 275. —— "Doing Business" in More than One State.

For present purposes, it is not necessary to consider the extremely technical subject of what constitutes "doing business" in a state. Nor are we concerned with standards which determine whether or not it is necessary for a corporation to seek authority from a state other than the state in which it is organized. Company counsel must advise on this point, and even he must carefully examine the law of the particular state in question.

§ 276. —— Through Subsidiary Corporations.

Many large corporations will be found to have incorporated in one state while doing business in other states through the media of separate subsidiary corporations, each of which is incorporated in one of the other states. In such cases, the primary corporation, the "parent," operates in the "foreign" state through its ownership of capital stock of the "subsidiary" corporation. Many railroad systems are so operated, each subsidiary owning that part of the system which lies within its state of incorporation.

§ 277. Selecting State of Incorporation.

The state of incorporation is naturally determined by the principal place from which the corporation intends to conduct its business. However, other consid-

erations may control the selection. Since a corporation is controlled by the corporation laws of the state in which it is organized, the place of incorporation may be determined by a preference for the incorporation laws of a particular state.

Comparatively lax corporation laws once made New Jersey and more recently Delaware, corporate havens. Most lawyers are familiar with the notice boards in the buildings occupied by "corporation companies" located in Delaware which are engaged in the business of acting as "resident agents" for "nonresident" corporations incorporated in Delaware. These notice boards frequently list hundreds of "nonresident" corporations incorporated in Delaware, which maintain the required "statutory office" in Delaware at the office of the "resident agent".

§ 278. —— "Bidding" for Corporate Business.

Frequently, the legislatures of some of our states actually "bid," with lax corporate laws or low corporation taxes, for the privilege of incorporating companies, so that the volume of such incorporations may yield the state revenue and its citizens business they otherwise would not receive.

The prevalent practice of Nevada offering divorce laws easy of compliance is a more widely known example of this practice, also prevalent but less notorious in the corporate field.

§ 279. —— Remote Place for Stockholders' Meetings.

Another motive which sometimes results in the selection of a state for incorporation remote from the place where the corporate promotors intend to distribute the

stock of the corporation is found in the desire of some corporate organizers to make it inconvenient for stockholders to personally attend corporate meetings.

§ 280. Certificate of Incorporation.

§ 281. —— Charter.

A business corporation is organized by filing in the designated state office a "certificate of incorporation." This is otherwise known as the "corporate charter."

§ 282. —— Contents.

The certificate of incorporation expresses the choice of the organizers of the corporation as to the name of the corporation, the amount of its capital, the number of its directors and the length of its existence. It also designates the business in which the corporation intends to engage and the principal place from which such business is intended to be conducted. It likewise makes provision concerning other miscellaneous matters; all of these matters of detail being largely dependent upon the provisions of the corporation law of the particular state of incorporation.

§ 283. —— Amendment.

The certificate of incorporation, though controlling while in force, may be amended at any time, by compliance with the terms of the particular state statute.

§ 284. —— Corporate Name.

The corporate name is largely a matter of choice of the organizers. Usually, however, it is subject to the limitation that it must not so closely resemble the name

of another corporation of the state as to cause confusion or conflict.

Also, under many state statutes, the corporate name must indicate that it designates a corporation by including the word "corporation" or its equivalent—"incorporated," "limited," or their respective abbreviations. The obvious purpose of this requirement is to inform persons with whom the corporation may deal that its liability is limited to the corporate property, so they may not give it credit upon the false assumption that those interested in it will become personally liable for the corporate debts.

However, it may be noted parenthetically that though an enterprise is conducted by a corporation, its stockholders may have a liability, in case of its insolvency, to its creditors beyond the loss of their investment in the stock. Invariably, stockholders are liable for unpaid assessments on their stock. The common and most prevalent example of liability is found in the case of banks where, by statute, the stockholders may be required to pay an additional amount (pro rata to the par value of their stock but not in excess of that amount) required to pay the claims of creditors. In some states, under some circumstances, stockholders may be subject to liabilities for taxes or labor claims.

In some states, too, the corporate name of an ordinary business corporation may not include words which might lead people to believe the corporation to be a financial institution. Such words as "bank," "investment," "trust," "fiduciary," are usually found in this category.

§ 285. —— Corporate Franchise—Duration.

Generally, state statutes permit corporate enterprises to continue indefinitely or for limited periods of years, at the option of the corporate organizers. The corporate charter expresses the organizers' choice in this regard.

Ordinarily, state statutes permit a corporation to obtain an extension of its corporate existence, where it has been initially limited, by filing an amendment to its original charter.

§ 286. —— Nature of Corporate Business.

The corporate organizers are required to define in the certificate of incorporation the nature of the business in which the corporation intends to engage. The primary purpose of this is to prevent an ordinary business corporation from engaging in a business which the state law restricts to a special type corporation such as banks or public utility corporations.

§ 287. —— Place of Business.

The place specified in the certificate of incorporation as the principal office for the conduct of the corporate business is ordinarily a mere formality since that place is only what is called the "statutory office" of the corporation. As indicated, this need not be the place where the corporation actually does its business. For an extreme example, a utility company owning all its properties in the state of Washington and supplying electricity in a large portion of the state, has its statutory office in Boston, Massachusetts.

§ 288. —— Incorporators and Initial Directors.

The certificate of incorporation is signed by the "incorporators" or "organizers," whose number and qualifications are specified by the state statute.

The incorporators need not be the actual persons who intend to conduct the corporate business or to manage its affairs as stockholders, directors, or officers. As a matter of convenience, the incorporators are usually persons employed by the lawyer or corporation agent retained to organize the corporation, and who otherwise have no interest in the corporate venture.

§ 289. —— Filing of Certificate.

The certificate of incorporation is filed in the office of the state and other offices designated in the corporation statute for the purpose.

§ 290. —— Organization Tax.

Upon the filing of a certificate, the state exacts, beside a stated filing fee, an "organization tax," which is usually fixed at a specified and varying percentage of the amount of the authorized capital of the corporation.

One of the favored methods of bidding by states for corporate business, as previously noted, is a lowered rate of organization tax. While this practice attracts legitimate but thrifty corporate organizers to the "bidding" states, it also offers opportunity to illegitimate, impecunious stock promotors of uranium and other mining claims to capitalize "watered" properties for millions of dollars of corporate stock.

§ 291. Completing Organization.

Once the certificate of incorporation is filed the cor-

poration comes into existence and the enterprise is "incorporated." Its organization is then completed by having the directors named in the certificate adopt bylaws, elect officers, authorize the issuance of securities and take such other action as may be necessary to launch the corporate venture. Nominal directors named in the certificate resign, one at a time, and the real parties in interest are serially substituted as directors before the corporate organization meeting proceeds.

§ 292. Bylaws.

The bylaws are a set of rules, basically standard, which supplement the certificate of incorporation and make more detailed provision for the regulation of the affairs of the corporation.

Generally, the bylaws contain the necessary provisions for meetings of stockholders and directors, specify the officers of the corporation, outline their duties and responsibilities and provide for a corporate seal.

The subject of the bylaws is discussed in greater detail later.

§ 293. Officers.

The officers of the company constitute its executive operating management. The bylaws usually provide for the conventional officers, a president, one or more vice-presidents, a secretary and a treasurer. They may provide for a chairman of the board of directors. The bylaws may provide for such other officers as may be required, a comptroller, an auditor, general counsel, as well as for assistants to the respective officers.

The bylaws invariably specify that the president is the chief executive officer of the corporation, the vice-

president his available substitute; they charge the treasurer with responsibility for the corporate funds and entrust the secretary with the care of records of the corporation. Generally, they specify the duties of the respective officers.

§ 294. Corporate Seal.

Though the "seal" is a relic of the days when medieval barons, who could not read or write, used their rings to make a characteristic impress, nevertheless, the seal remains in our corporate law as a physical impression made upon written documents executed by the corporation. Its purpose is to supplement the signatures of corporate officers and thereby authenticate the document and is required on stock certificates, bonds, indentures, mortgages, deeds and other formal contracts of the corporation.

§ 295. Capital Structure.

The total amount of the securities issued by a corporation constitute its "capital structure." To what extent this consists of bonds, preferred stock and common stock, or one or more of them, is a matter of incorporators' choice evidenced by the certificate of incorporation.

§ 296. —— Corporate Securities.

State statutes prescribe the requirements for and limitations upon security issuance. In addition, there may be special state or federal statutes that must find compliance before securities "authorized" by the certificate of incorporation may be "issued."

§ 296a. "Authorized" vs. "Issued".

The authorized securities are those which the certificate of incorporation permits the corporation to issue. The issued securities are those which the corporation actually issues.

§ 296b. Restrictions on Amounts of Preferred Stock.

In some states, there are statutory restrictions placed upon the amount of preferred stock to be issued. The particular provisions which constitute the "preferences" are also frequently the subject of state law cognizance.

§ 297. —— Capitalization Ratios.

Ordinarily effort is made to insure a reasonable ratio between the amount of corporate bonds, preferred and common stock, authorized or issued.

Supervisory governmental bodies have rules of thumb, percentages which furnish conservative standards for issuance of securities. A maximum of fifty percent of bonds, twenty-five percent of preferred stock, leaving twenty-five percent of common stock, constituting the total capital structure, is usually considered reasonable corporate financing.

§ 298. —— Registered Bonds.

Bonds may be "registered" in the name of the purchaser or holder. Only the person in whose name the bond is issued or to whom it is transferred on the books of the company, or its transfer agent, may claim rights under "registered bonds." In the case of "registered bonds," the company keeps a record of the holders and

mails an interest check to each holder on each interest date.

§ 299. —— Coupon or Bearer Bonds.

It is more usual that a bond should be a "bearer" or "coupon" bond, which is payable "to bearer" instead of to a registered holder. "Bearer" bonds have attached numbered coupons, each calling for a semiannual interest payment on a fixed semiannual interest day, payable to the holder on presentation.

Coupon bonds are transferable by delivery—while registered bonds must be assigned in writing by the registered holder and the transfer recorded on the books of the company.

§ 299a. Paying Agents.

A company with outstanding bonds designates a paying agent to which it pays, immediately prior to each interest date, the total amount of interest payable on the entire outstanding series of bonds. The paying agent mails an interest check to the registered holders of registered bonds. The holder of each bearer bond clips his coupon and, in person or through his bank, presents the coupon to the company's paying agent and in that manner collects his interest.

These provisions for registration or bearer coupons are common to all issues of bonds.

§ 300. —— Mortgage Bonds.

The highest form of corporate obligation is known as the "mortgage bond." It is so called because the repayment of the corporate debt and interest evidenced by the bond is secured by a mortgage on all or some

of the corporate assets, usually its fixed assets, real estate, plant and machinery, which is known as the "collateral."

§ 300a. Equipment Trusts and Collateral Trusts.

The collateral securing a bond issue may be various forms of property. Where, for example, it is railroad rolling stock in use, the bond issue is termed an "equipment trust"; where the collateral is personal property, such as shares of corporate stock, the bond may be called a "collateral trust" bond.

§ 300b. First Lien Mortgage Bonds and General Mortgage Bonds.

Mortgage bonds may be secured by a first lien on the mortgaged or pledged property, in which event the issue will be known as "first mortgage" bonds. Or they may be secured by a second, third, or even a fourth lien on the pledged property. In such cases, they may be denominated accordingly, or termed "general mortgage" bonds.

§ 300c. Debentures or Notes.

A bond is not necessarily secured by a mortgage or pledge of collateral. It may be a mere promise of the company to pay—the equivalent of a "note"—without security other than the general credit of the issuing company. In those instances, in case of default, the holders of these bonds become mere unsecured creditors, who like merchandise, bank or other unsecured creditors of the company, must look to the general assets of the company, in common with all other creditors, for repay-

ment of their debt. Unsecured bonds are known as "debentures," or they may be termed "notes."

§ 300c1. Secured Debentures.

An issue of "debentures" may be accompanied by an indenture and may be said to be "secured" thereby, though no collateral is pledged or mortgaged as security. In such cases the indenture is really a mere "loan agreement" containing the terms upon which the debentures have been issued. These ordinarily include limitations upon the issuance by the company of prior or equal ranking obligations, provisions for retirement and redemption of the issue, and the like.

§ 300d. Serial Bonds.

Frequently, amortization of an issue of bonds is effected by issuing bonds in series, some payable at the end of each year and, in such case, the term "serial" may be employed as part of the denomination of the bond.

§ 300e. Convertible Bonds.

Bonds may also be denominated "convertible" by reason of giving the holder the privilege of exchanging them for stock of the company at specified prices, at specified times. This is similar to the common stock conversion features of preferred stock.

§ 300f. Gold Bonds.

The once common term of "gold bonds" became anachronistic when the United States Supreme Court held that bonds payable in "gold coin" could be paid in other forms of legal tender.

§ 300g. Income Bonds.

While a bond ordinarily represents a fixed obligation of principal and interest, there are also such hybrids as "income" or "contingent income" bonds. When borrowing money on a bond issue, a corporation may contract that it is not obligated to pay interest except when and as it is earned. In such cases the bonds, as to interest at least, impinges on the realms of preferred stock.

The purpose of the income bond may be to secure a tax deduction for interest paid not available to a corporation paying preferred stock dividends. Within a recent period, railroads have issued income bonds upon reorganization in preference to preferred stock for this reason; even more recently, they have issued debentures in exchange for outstanding preferred stock.

§ 300g1. Cumulative and Noncumulative Interest.

Again, akin to preferred stock dividends, interest on an income bond may be cumulative or noncumulative and, if the former, any unpaid interest below the prescribed rate may become a corporate debt payable with the principal obligation on its due date. Or a bond may be a hybrid, carrying fixed interest up to a certain rate and interest beyond that, up to a specified rate, payable contingently, usually when and as earned. In such cases, the additional interest may or may not be cumulative.

§ 301. —— Indentures.

§ 301a. Indenture of Mortgage; Collateral Trust Agreement; Pledge; Lien.

The instrument by which the corporation mortgages its real property, or pledges its personal property, is known as an "indenture of mortgage" in the case of a mortgage of real property, a "collateral trust agreement" in the case of a pledge of personal property. The indenture creates a "lien" on the corporate property which "secures" payment of the corporate obligation.

§ 301a1. Indenture Trustee; Security.

The indenture is an agreement made between the corporation and a "trustee" (commonly known as an "indenture trustee" or a "corporate trustee"), by which the corporation mortgages or pledges the title to its property as "security" for its debt.

§ 301a2. Trust Property.

The indenture trustee has a lien on the mortgaged property and sometimes holds the possession of the pledged property—known as the "trust property," the "trust fund," the "trust *res*," the "collateral," or the "pledged property"—as security for the payment of principal and interest of the entire issue of bonds. The indenture states the terms and conditions of the mortgage or pledge, and when and how the trustee shall proceed to protect the rights of the holders of the bonds in the event of an "act of default" by the company.

§ 301a3. Trust.

The terms of the indenture usually are said to create

a trust for the benefit of the bondholders, although, on occasion, the "trust" may be illusory. For example, in one case, a bank succeeded in inducing the highest court in New York to hold that the language of the indenture created no trust, and consequently, when sued for a breach of trust, the bank was not liable.

§ 301a4. Trustee's Duties.

The indenture specifies the trustee's duties and usually provides that only the trustee may act for the bondholders in the event the company defaults in payment or performance of its obligations. In some cases of debenture issues, the holder can sue the company directly if it fails to pay principal or interest. In the case of a secured bond, the indenture usually provides that the trustee may, but need not act, unless the holders of a percentage of bonds, usually 25%, request it to do so, and also indemnify it against the cost of taking action. There are bond issues in default where the trustee has done nothing for years because of the presence of some such clauses in the indenture.

§ 301a5. Sinking Fund.

Indenture provisions may require the issuing company to "amortize" the principal of the bonds, by creating a "sinking fund" into which the company makes periodic deposits on account of the unpaid principal of the outstanding bonds. These moneys, so deposited, may be employed, depending on the provisions of the indenture, to retire bonds by purchase in the open market, by advertising for tender of bonds or by retirement of specific bonds by lot.

Some indentures provide that instead of cash amor-

tization payment, sinking fund requirements may be satisfied by the deposit, for cancellation, of bonds. This enables a company to buy in its bonds in the market, usually at prices under par and thus reduce the outstanding issue by sinking fund deposits which aggregate less than the amount of cash which otherwise would be required.

§ 301a6. Right of Vote.

It might be noted that under particular statutory and contract provisions, bondholders may have a right of vote, either singly, in common with other security holders, or as a class. Such provisions are, however, usually found only in bonds issued in a corporate reorganization.

§ 302. —— Classes of Stock or Series.

Preferred or common stock may have a par value or may be of no par value. Both classes of stock, or either, may be subdivided into classes or series and these classes or series may be coordinate in terms or rank, or one class or series may be preferred, in one or more respects, over another.

§ 303. —— Preferred Stock.

§ 303a. Conventional Preferences — Dividend Preference; Liquidation Preference.

The conventional form of preferred stock provides that it shall have a dividend, at a rate specified, in priority to any dividends paid on the common stock; also that on liquidation of the corporation the capital represented by the preferred stock shall be paid in priority

to any distribution to the common stockholders. The first mentioned preference is known as a "dividend preference"; the latter as a "liquidation preference."

§ 303b. Cumulative Dividends.

The dividend preference may call for "cumulative dividends." This requires that the preferred stockholders shall either receive or be credited with the specified annual dividend. If a preferred cumulative dividend is not declared in any year or years, the unpaid amount is added to the corporate obligation for the following years, until it is paid. Meanwhile, the common stockholders are barred from receiving dividends on their stock.

§ 303b1. Unpaid Dividends Not Debt.

However, the unpaid cumulative preferred dividends are not considered a debt of the corporation, since a dividend, though otherwise owing, does not become a debt of the corporation until it has been "declared" by the directors. Consequently, the amount of unpaid dividends, though cumulative, is not carried in the corporate balance sheet as a liability.

However, in the event of the liquidation of the corporation, all unpaid cumulative preferred dividends must be paid before the common stockholders may receive their distributive share of the net assets. This provision is usually part of the preferred stock "liquidation preference" found in the corporate charter.

§ 303c. Noncumulative Dividends.

Dividends, though preferred, need not be cumulative. In such case, if the dividend is not earned and declared

payable by the directors in any one year, the preferred stockholders lose their right to receive it for all time.

In some states, principally New Jersey, the courts have endeavored to mitigate the rigor of this rule. The New Jersey courts, for example, hold that if the corporation has sufficient earnings in a particular year to justify the directors in declaring a dividend on noncumulative preferred stock, the mere fact that the directors fail to declare such dividend in that year will not prevent the dividend from becoming cumulative. In such cases, the usual consequences attendant upon nonpayment of a cumulative preferred dividend follow, i. e., no payment of dividends may be subsequently made to common stockholders, until the unpaid preferred dividends have been declared and paid.

The most recent case of note in this connection required the American Car and Foundry Company to so regard unpaid noncumulative dividends on its outstanding preferred stock.

§ 303d. Other Preferences.

A stock need not have conventional preferences to be termed a "preferred stock." Except as statutes provide otherwise, any stock may be called "preferred" if it has any. so-called advantage over any other stock issued by the corporation and even if it has no preference in dividend payment. Bearing on this, when, a few years ago, effort was made to insert in the New York corporation law a provision that no shares should be called "preferred" unless they had a prior preference of dividends and assets, the legislators, under some undisclosed contrary pressure, "compromised" by say-

ing that no shares entitled to preference of dividends or assets should be designated "common stock."

The fact is that "preferences"—whatever they may be—may be hedged about with so many "ifs," "ands" and "buts" that the "preferences" may be illusory.

§ 303e. Special Type Preferred Stocks.

In some states, it is possible to issue interest-bearing and other special types of stock.

§ 303e1. Example.

An example of a rare special stock was furnished by an issue of the Southern Railway Company employed to exchange for a conventional common stock of the now defunct Mobile and Ohio Railway. This special issue entitled the holder to $4 per annum as interest forever—"in perpetuity"—with no privilege in the railroad to call or retire the stock. Upon the bankruptcy of the Mobile and Ohio, Southern Railway contended that its obligations upon the issue ceased. But the courts refused to subscribe to this contention and the security is still listed upon the New York Exchange.

§ 303f. Dividend Rate.

When a preferred stock has a par value, its dividend rate is specified by a percentage of its par value or a fixed amount, payable annually or more frequently.

If the stock is of no par value, the dividend rate is specified in dollars.

§ 303g. Additional Dividend Rights; Participating Preferred.

Preferred stock may also carry contingent rights;

it may have a limited or unlimited right to share with the common stock in the additional profits of the enterprise. A preferred stock of this nature is called "participating preferred."

§ 303h. Convertible Preferred.

A preferred stock is frequently convertible, at the option of the holder, at a given ratio, into common shares. Such stock is aptly termed a "convertible preferred."

§ 303i. Redemption or Call.

It is customary when issuing preferred stock, to provide that the corporation may call—retire—it at any time, or upon any dividend date, at a fixed redemption or call price. The call price may be par, but it is usually fixed to include a premium to the holder above the liquidation preference which, in turn, as noted, ordinarily is the par or stated capital applicable to the stock. For example, the Wheeling and Lake Erie Railroad called its outstanding $5\frac{1}{2}\%$ preferred stock at par.

Upon redemption, the company is ordinarily required to pay all unpaid cumulative dividends. Frequently, the company is given the right to redeem part of its outstanding preferred stock and, in such cases, it may purchase stock in the open market, it may call for tenders by stockholders, or it may redeem stock chosen by lot, according to the terms of the issue.

§ 303j. Sinking Fund.

A preferred stock issue may make provision that the company will set aside periodically a stated percentage

or sum out of profits, for the retirement of the issue. This, like similar provision more customary in the case of bond issues, is known as a "sinking fund."

This sinking fund feature is a method of compulsory redemption, which may be set up so as to redeem the issue, wholly or partly, by maturity. It may operate in one of the three means previously specified for voluntary partial redemption.

§ 303k. Noncallable Preferred.

Preferred stock may be noncallable.

§ 303-l. Vote.

Preferred stock may or may not be entitled to vote. However, in some states, the corporate statutes require that all issued shares, whether of preferred or common stock, carry a right of vote.

§ 303-l.1. Upon Default.

Regardless of statutory requirements, the better prevailing corporate practice is to assure preferred shareholders a voting participation in the enterprise when preferred dividends are in default.

These provisos vary. Most of them require that a certain number of dividends be passed before the preferred shareholders' right of vote becomes effective. When the specified number of defaults have occurred, the preferred shareholders are usually accorded the right, as a class, to elect a specified number of directors to represent their interests. The number to be so elected varies; in some cases, the preferred shareholders become entitled to elect a majority of the board.

These details depend upon the contract under which the preferred stock has been issued. In special cases, under particular statutes, such as the Federal Investment Act of 1940, and Chapter X of the National Bankruptcy Act, specific requirements are found.

Protection to the preferred shareholder is often negated, after the stipulated preferred dividend defaults, when the management solicits proxies for management representatives to "represent" the preferred stock, and through its control of the proxy machinery, elects them, or itself acquires sufficient preferred stock to perpetuate its control.

§ 304. —— Common Stock.

The common stock represents the control and management of the corporation. Each share of common stock represents a proportionate share in the net assets of the corporation and an aliquot share of the capital and net profits of the business.

§ 304a. Vote.

The common stock usually carries the voting control of the corporation. Ordinarily each share of common stock carries a single vote.

§ 304b. Classes or Series.

However, common stock, like preferred, may be issued in classes or series, and the vote and dividend rights may vary between the stock in the various classes or series.

§ 304c. Management Stock.

On occasions in the past, a separate class of common

stock, carrying a preponderance of the vote over publicly-issued common stock, might be issued to the promoters. This came to be known as "management" or "founders' " stock.

Where this practice prevailed, the publicly-issued common stock was distinguished from the management common stock by varying alphabetic—"A" and "B"—designations. In some cases, the preponderance of vote was assured by having the publicly-held stock carry one vote per share, while the management stock carried ten or even more votes per share.

§ 304d. Watered Stock.

A practice still indulged in in wildcat mining promotions is to issue the voting stock to the corporate organizers for false, fictitious or over valued considerations, in violation of the statutory provisions that require stock to be issued only for full and fair considerations; stock so issued is known as "watered stock." However, various state "Blue-Sky Laws" and the Federal Securities Act have been reasonably effective to halt, or at least impede such practices.

§ 304e. Fractional Shares.

The unit of authorized stock is a single share. On occasions, particularly when a stock issue is being readjusted, or a stock dividend is being declared, a shareholder may become entitled to receive less than a single share of stock. In such cases, "fractional shares" may be issued.

§ 304f. Scrip.

In lieu of issuing fractional shares, the corporation

may be authorized to issue "scrip" evidencing the shareholder's right to a credit in fractional shares (and sometimes to a money equivalent). A shareholder who accumulates sufficient scrip turns it into the corporation, which then issues its equivalent in full shares.

§ 304g. Stock Warrants.

A corporation may also be authorized to issue "stock warrants" which entitle the holder to subscribe for a specified number of shares of stock, at a specified price or prices, over a specified period.

§ 304h. Stock Options.

The issuance of stock warrants is one method of having the corporation give continuing options to subscribe for its unissued stock, or to purchase its treasury stock. Sometimes this is done by contract, usually to provide incentive to executives to increase corporate profits and thereby make the stock, and the option to acquire it, more valuable. (The practice is abused by unscrupulous promoters.) When stock options are granted by contract, they are exercisable only by the persons designated in the contract. When they are created by the issuance of stock warrants, they run to the holder of the warrant, which are usually transferable in the same manner and under the same conditions as the stock itself.

Stock warrants are frequently issued in reorganization proceedings to give some recognition to common stockholders whose interests are otherwise being wiped out.

§ 305. —— Unissued vs. Treasury Stock.

With warrants, stock options or scrip outstanding, a corporation must have and keep available the amount of stock called for by its outstanding obligations. Such stock may either be unissued stock or "treasury stock," that is, stock which the corporation has once issued but which it has reacquired from the former holders.

§ 306. —— Guaranteed Stock.

Ordinarily, one corporation may not pledge its credit for the purposes of another corporation. The law calls this "*ultra vires*"—outside the scope of the corporate authority. However, under some conditions of corporate inter-relationship, a corporation may, and frequently does guarantee payment of obligations of another corporation. Such guaranteed obligations may and frequently do include dividends on outstanding corporate stock. Such stock is commonly known as "guaranteed stock."

The most common type of this guaranty is found in railroad stocks, when one railroad leases the lines of another or otherwise uses or controls its facilities.

§ 307. Issuance of Stock.

The new corporation obtains its initial funds by issuing its authorized capital stock to purchasers who "subscribe" for it.

§ 308. —— Stock Subscriptions.

The contract whereby the purchaser subscribes for stock is known as a "stock subscription." Most states require that stock be issued only for its equivalent in money, property or services.

§ 309. —— Securities Acts—Blue-Sky Laws.

When issuing stock, a corporation must be alert to comply with the applicable federal and state laws. Today, with certain limited exemptions, stock may not be sold publicly without filing a registration statement with the Securities and Exchange Commission, under the provisions of the Federal Securities Act of 1933.

In addition, a number of states have statutes—generally known as "Blue-Sky Laws"—that regulate the sales of corporate securities within their borders. Some of these laws require security dealers to be licensed and the Federal Act likewise provides for "registered dealers."

It might be noted that a state "Blue-Sky Law" may require licensing before a particular stock may be sold in the state. Such a statute vests in the licensing authority a discretion to refuse to permit sales if the stock issue does not meet prescribed requirements. On the other hand, the Securities and Exchange Commission has no such power. It is limited to compelling complete disclosure by the filing of a registration statement by the issuer of the securities and has no licensing jurisdiction.

§ 310. Par and No Par Stock.

Stock has either a par value or is designated as having no par value.

§ 311. —— Par Value.

The par value of a stock is a purely arbitrary amount which, by the certificate of incorporation, the incorporators fix as representing the amount for which each share of stock is to be issued.

§ 311a. Consideration for Stock.

As indicated, the law generally requires that, when a par value stock is issued, an equivalent amount in cash, services, or property be paid into the corporate treasury. Any excess paid goes into the corporation's "paid-in capital surplus," as in the case of no par stock.

§ 311b. No Par Stock.

In most states, a corporation may issue "no par stock." In such cases, it is left to the directors to fix the amount for which stock shall be issued from time to time, without the restriction of a fixed par value.

Some states permit both preferred and common stock to be no par; others restrict the privilege to common stock.

§ 311b1. Varying Considerations.

In the absence of statutory restriction or fraud, no par stock may be issued for varying sums at different times, so that, if the corporate assets shrink, unissued no par stock may be properly issued for lesser considerations than were the prior issuances. On occasion, a low par stock may have tax advantages to both corporation and stockholder over a no par stock.

§ 312. Capital Stock.

§ 313. —— Stated Capital.

The "capital" of the corporation is fixed at the equivalent of the par value of the stock issued. If the stock has no par value, the stockholders or directors determine what portion of the amount for which the stock is to be issued shall be considered "stated capital." This

"stated capital," plus the aggregate of the par value of any issued par value stock, constitutes the "capital" of the corporation.

§ 314. —— Capital or Paid-in Surplus.

As noted, any premium received over the par value of issued stock becomes "capital surplus," as does any excess over the amount determined by the directors to be "stated capital" for no par stock.

When property is taken in for stock, the directors, whose appraisal is final in the absence of fraud, may be high or low in their estimate of its worth and the "capital" of the corporation will, in fact, be proportionate to the validity of the appraisal. On the other hand, if the "property" for which the stock is issued be nebulous, like "good will," or "patents," or "services," the corporate capital may be no capital at all and a "paid-in surplus" would then be equally fleeting and elusive.

§ 315. —— Full Paid and Nonassessable.

The average stock certificate will be found to have printed or engraved thereon the words, "full paid and nonassessable". This is a relic of the day when promoters issued par stock for insufficient considerations, "good will," "patents" or "services." Today, the incidence of no par stock makes the assuring phrase an anachronism.

§ 316. —— Stock Certificates.

§ 316a. Registration.

As between the corporation and the stockholder, the

latter's stock interest in the corporation is evidenced by a numbered "stock certificate" which is registered in the name of the holder on the books of the corporation.

§ 316b. Transfer.

A stock certificate is transferred by the stockholder whose name appears on its face, signing a form of assignment which is usually printed on the back of the stock certificate.

§ 316c. Assignment in Blank.

If the name of the person to whom the certificate is being assigned is not filled in, the certificate is said to be "assigned in blank." Thereafter the certificate, in that form, can be validly transferred from one person to another by mere manual delivery; at least until someone fills in the name of an assignee.

§ 317. —— Corporation Recognizes Registered Holder.

Nevertheless, and regardless of who actually owns a certificate, the corporation is required and entitled to recognize as its stockholder, for purposes of proxies, paying dividends and other corporate purposes, the person whose name appears on its books as the registered owner until someone presents the certificate, properly assigned and with the necessary tax stamps attached, for transfer into another name upon the corporate books.

§ 318. —— Stock Records; Registrar or Transfer Agent; Stockholders of Record.

The records of stock issuance, registration and trans-

fer are kept in corporate books variously called "stock certificate book," "stock ledger," "stock transfer book." When the corporation has outstanding stock in the hands of numerous public holders, it usually designates a bank or trust company to act as "registrar," "transfer agent," or both. These books reflect the "stockholders of record."

§ 319. —— Closing Transfer Books.

The stock transfer books are usually closed for a period preceding the annual meeting of the corporation, so that a definitive list of shareholders entitled to vote may be compiled. In such situations, only those stockholders of record as of that date may vote; subsequent transfers are not recognized for voting purposes.

In some corporations, it is still the practice to close the books for dividend-paying purposes. However, the general practice of paying dividends on a certain fixed date to stockholders of record on a previous fixed date, which meets the requirements of the New York and other Stock Exchanges, makes closing of the transfer books unnecessary. A transfer of the stock after the dividend date does not carry with it the right to the dividend; the stock sells "ex-dividend" as of the record date fixed by the directors when declaring the dividend.

§ 320. —— Street Certificates; Unclaimed Dividends.

A considerable percentage of the stock of the listed stock of our public corporations stands in the names of brokerage houses, who have long since transferred the certificates in blank. These certificates in brokerage names are said to be in "street names"; they pass from

sellers to purchasers without presentation for change of registration on the corporate books.

§ 321. —— Lost Stock Certificates.

When stock certificates are lost or destroyed, state statutes generally provide for their replacement. The customary practice is to require an affidavit establishing the loss and a bond, running to the corporation, indemnifying it against damage arising from claims on the replaced stock certificate.

§ 322. —— Voting.

§ 322a. Voting Trusts.

A legal device, generally not presently favored in public corporations but employed in the past, particularly in railroads presently emerging from reorganization, is to place voting stock in a trust which conveys to trustees the right to vote it. This enables corporate control to be vested in "voting trustees" for a designated period of years, five or ten years being the period usually fixed as the limit by statutes. Instead of the stock carrying a vote, the stockholders receive a "voting trust certificate," which carries no vote.

This device is often a necessary one in a small private corporation where, for example, management undertaking to build up a business wants the assurance of continuity and continued support by stockholders who, again for example, may have inherited their stock from former members of management. But it has little place in large public enterprises.

§ 322b. No Vote on Treasury, Unissued or Subsidiary Stock.

In order to limit management control, the law does

not ordinarily permit a corporation to vote its own unissued or treasury stock, or its own stock held by wholly owned subsidiaries.

§ 323. Accounting Practices.

§ 324. —— Profit and Loss Statement.

A current earning statement is designed to show profit earned or loss sustained during a given period. A balance sheet shows the corporate assets and liabilities, the capital and surplus or deficit account at the end of a given period. Most companies compute profit or loss monthly, quarterly, semiannually and annually, and prepare a monthly balance sheet.

§ 325. —— Balance Sheet.

Generally, a balance sheet itemizes the assets and liabilities, so that, after deducting from the difference between them the amount of capital represented by the outstanding capital stock, the corporate surplus or deficit may be determined.

§ 325a. Net Worth; Book Value.

From the balance sheet figures, the net worth of a business can be computed and the book value of the outstanding stock determined by dividing the capital plus surplus or minus deficit, by the number of outstanding shares.

§ 325b. Current Assets.

The assets appearing on the balance sheet are divided into current assets and fixed or capital assets, the former consisting generally of cash, or its equivalent in readily

marketable securities, inventory, accounts receivable; the latter of plant, machinery, equipment and similar items.

§ 325c. Fixed Assets.

Fixed assets are usually shown at cost with a deduction for depreciation, the net amount being added as an asset. Or the gross value of fixed assets may be carried on the asset side of the balance sheet with a "reserve for depreciation" carried on the liability side.

Some corporations publish their earnings and issue a balance sheet semiannually. Others include a balance sheet only in the annual report at the end of the calendar or fiscal year, whichever has been adopted by the corporation for tax purposes. The present tendency is towards prompt release of information; a quarter-annual report of earnings is generally favored.

§ 325d. Items.

Generally, an earning statement shows gross earnings over the period it reflects, cost of sales or operations, net receipts thereby created, proper deductions, including accrued depreciation, tax and fixed interest charges, leaving and showing surplus profits available for dividends. Included in this statement are increases of or deductions from the value of inventory when last taken. Inventory value reflects raw material on hand, taken at cost or market, whichever is lower, with labor and overhead costs added for materials in work or finished. Methods of evaluating inventory include the "Lifo" method which enables inventory to be carried at earlier valuations where increasing values would result in higher tax charges.

Whatever the nature of the corporate business, the

items comprising the equivalents of the terms just used will be found as factors determining the profit or loss for the current period.

§ 325e. Other Assets.

Intangible assets, such as good will, patents, organization expense, etc., may also be capitalized but to do this has become increasingly bad form. Such items are therefore usually carried in the balance sheet at a value of $1.00 in spite of the fact they may actually be of great value.

Unexpended advance payments for items such as insurance, deposits, and the like, may properly be capitalized in the asset column.

§ 325f. Liabilities.

§ 325f1. Current.

On the liability side of the balance sheet, current liabilities appear as the first items. Generally, these include all those accruing within twelve months.

§ 325f2. Long Term.

Long term bank loans, funded indebtedness, notes and other obligations, fixed and contingent, are carried separately. The amount represented by the outstanding stock is also shown as a liability. However, unpaid dividends on preferred stock, though cumulative, are not considered or carried on the balance sheet as a liability.

§ 325g. Net Current Assets or Working Capital.

In reading a balance sheet, the net current assets, the current assets less the current liabilities, constitute

"working capital," as distinguished from "net worth" or "surplus."

§ 325g1. Ratio of Working Capital.

The sufficiency of working capital is commonly measured by the ratio that current assets bear to current liabilities. The commonly accepted standard requires that the ratio shall not fall below two to one. Of course, cash as well as net working capital must provide a sufficient margin for the needs of the business.

Decrease of working capital is not necessarily harmful, providing a sufficient reserve of working capital remains. On the contrary, low working capital may merely mean that the past year has seen proper reinvestment of the corporate funds in assets that may be expected to yield added future profits. A reduced working capital, however, may also indicate losses.

§ 326. —— Consolidated Statements.

When a corporation operates through wholly owned subsidiaries, it is customary to show over-all operations and results, as well as the operations and results of each separate corporation. The former practice results in a "consolidated earning statement" and a "consolidated balance sheet," as distinguished from a "corporate earning statement" and a "corporate balance sheet."

§ 327. —— Accountant's Certificate of Audit.

It is the accepted practice that published figures be accompanied by an auditor's certificate attesting its agreement with the books. Tentative and unaudited figures are frequently published as such, in order to

release prompt information, and are followed subsequently by a report certified by the corporate accountant.

§ 328. Increase or Reduction of Capital.

We have already pointed out the distinction between "capital" and "capital stock." A corporation may increase or reduce its capital, at any time, by increasing or reducing its capital stock, either in number of shares or par value. This is effected by taking the necessary proceedings prescribed by the respective state statute.

§ 329. Purchase vs. Reduction Stock.

A corporation that buys in its stock on the public market is not thereby "reducing" its capital or its capital stock. Instead, it is reducing the amount of stock "outstanding," or "publicly held." When stock is reacquired by the corporation, it becomes "treasury stock" and may be re-sold. Neither the capital nor the capital stock is thereby reduced unless statutory proceedings are thereafter taken to reduce the authorized capital and capital stock.

§ 330. —— Pre-emptive Rights.

When a corporation increases its authorized stock, statutes usually provide that it may not issue the excess stock, unless it first offers its existing stockholders the right to subscribe for their pro rata shares. This constitutes the stockholders' "pre-emptive rights." In some states, the charter may waive pre-emptive rights.

§ 331. Merger or Consolidation.

Corporations may merge or consolidate—the differ-

ence being technical—subject to the provisions of the federal Clayton and Sherman Anti-Trust and particular state statutes. This may be effected by one corporation merging into another, or by both consolidating to form a new corporation.

§ 332. —— Parent and Subsidiary; Holding Companies.

One company may acquire stock control of another, thus becoming "parent" and "subsidiary." A "holding company" may thus become parent to a number of subsidiaries, though some statutes restrict such practices in the cases of banks, utilities and other publicly tinged corporations.

§ 333. —— Dissenting Stockholders; Right to Appraisal.

For the merger or consolidation of a corporation, state statutes generally require the affirmative approval of a specified percentage of its stockholders. In such cases, as in other cases of radical alteration of the corporate enterprise, stockholders who dissent are usually accorded the right to receive cash payment equivalent to the fair value of their shares and statutory provisions are frequently found for the valuation of such shares by judicial appraisal.

In some states, consolidation of corporations is considered as a dissolution of those consolidated.

§ 334. Dissolution.

§ 335. —— Voluntary.

Though it is unusual for a going-concern corpora-

tion to dissolve, there are situations where a corporation no longer serves a useful function and its stockholders undertake to dissolve it. Dissolution is more common with small privately owned corporations than with large publicly owned ones. However, a recent Wall Street Journal article reported that the directors of the Merchants and Miners Transportation Company had recommended dissolution of the Company which, before the war, had operated a coastal shipping service which had since been discontinued.

§ 336. —— Involuntary.

Within recent years, there have been a considerable number of forced dissolutions of utility holding and subholding companies as a result of Securities and Exchange Commission action under the Public Utility Holding Company Act.

On some occasions, a state may compel a corporation to dissolve because it has violated the franchise which the state has granted to it. Hundreds of corporations are dissolved each year in states like New York and Delaware by blanket executive proclamation, for failure to pay state franchise taxes.

§ 337. —— Judicial.

Also, though rarely, one of conflicting stock interests may compel corporate dissolution by recourse to the courts. An equally balanced board in conflict, jeopardizing or preventing the continuance of the corporate business, sometimes results in such an application to the court, which may then appoint a receiver to liquidate the corporate affairs and distribute the proceeds of the assets to the creditors and stockholders.

§ 338. Liquidation.

"Dissolution" is the process of ending the corporate existence and is followed by a "liquidation" of the corporate business and affairs. While the corporation, as such, ends upon compliance with the state requirements for "dissolution," the customary legal provision is that the directors continue as "trustees in dissolution" for the purpose of winding up the corporate affairs.

§ 339. Bankruptcy.

§ 340. Receivership.

Liquidation of the affairs of a corporation usually follows when it becomes insolvent. Then bankruptcy usually occurs and the bankruptcy court takes jurisdiction of the corporate assets, appoints a receiver or trustee, winds up the affairs of the corporation and distributes its assets to its creditors. This is liquidation, as distinguished from dissolution. The corporation itself remains undissolved and any assets over and above those needed to pay its debts and the costs of the proceedings, revert to the corporation and its stockholders.

§ 341. Reorganization.

More frequently, when temporary embarrassment occurs, a corporation seeks reorganization, which is a proceeding, though under the Bankruptcy Act, that does not require liquidation but permits reorganization and resumption of the corporate business. Many of our large and presently successful corporations have obtained new leases of life through such proceedings; Paramount, among the moving picture companies, most of our railroads, McKesson and Robbins, and many others.

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